Islamic Banking and Finance—
The Concept, The Practice
and The Challenge

EDITED BY
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Foreword

The first ISNA conference on Islamic Banking and Finance in America evolved out of a session on Islamic Banking that was included in the 1997 ISNA annual convention. At the conclusion of the session and the convention, an overwhelming number of participants requested that we should focus in greater detail on this subject. Such ideas gave birth to an entire conference devoted to a subject that is very dear to all Muslims.

The creation of a viable economic future in this continent and the nuances of Islamic financing have been a major issue of concern for Muslim Americans. We are confident that the collective advice of Muslim experts and practitioners, and the thoughtful deliberations of Muslim financial experts will not only help answer the many financial questions, but it will also offer new ideas and opportunities and ventures that will contribute to the growth of Muslim financial strength in North America and across the Muslim World.

We are thankful to the members of the organizing committee who worked very devotedly to make this conference a success. Professor Imtiazuddin Ahmad as the Program Chairman approached the academic community. He and the other members brought a wealth of experience and contacts in this field. Dr. Mahmoud A. El-Gammal, as the Chair in Islamic Economics, Finance and Management at Rice University generously hosted the conference. Dr. Yahia Abdul-Rahman and AbdulKadir Thomas showed extraordinary resourcefulness in mobilizing human and financial resources to make the conference possible. Dr. Bassam Osman of North American Islamic Trust provided advice and insights about the issues involved in these experiments in America. Dr. Muzammil Siddiqi's blessings & support was an inspiration for all. Ahmad Elhattab as a roving ambassador of ISNA was able to approach practitioners of Islamic banking in the Muslim world and enlist their support. Tipu Ahmad, our director of Conventions and Conferences took the challenge of facilitating the participation of national and international guests & presenters. He undertook the step by step organization of the

conference.

The conference was cosponsored by Albaraka Investment and Development Company, American Finance House-LaRiba Bank, Boston Capital, First Islamic Investment Bank, Key Global Capital, North American Islamic Trust (NAIT) and United Bank of Kuwait- Al-Manzil. We certainly appreciate their participation and hope that their participation and sponsorship will continue in future. Our own regional affiliate, Islamic Society of Greater Houston showed great enthusiasm in cosponsoring the conference and hosting the guests. Dr. Moen Butt, the president of the ISGHI, the Shura and the entire community were very warm in their reception of the conference participants. The growth of these communities make us confident of the prospects for the development of Islamic institutions in America.

We would like to express our thanks to the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) for partially supporting the publication of the proceedings of this conference. The Islamic Society of North America is committed to strengthen this forum for thinkers, jurists, practitioners of Islamic banking, scholars, students, researchers and community leaders. We hope and pray that we will be able to get support and cooperation of all to make these conferences professionally more productive and Islamically more sound.

—Sayyid M. Syeed
Secretary General
Islamic Society of North America

INTRODUCTION

The Islamic Society of North America hosted its first International Conference on Islamic Banking and Finance from July 17 to July 18, 1998 in Houston, Texas. The conference was held at a time when the Southeast Asian countries were engulfed by a financial crisis caused by a flight of capital from these countries. Economists and financial practitioners were busy searching for reasons for this financial upheaval, whose impact was now spreading to the United States and Europe. In their analysis, they relied primarily on traditional tools of economic theory. The causes they identified ranged from the lack of mature institutions and inefficient financial controls, and the existence of highly concentrated and monopolized industries, to the pursuit of highly ambitious macro-economic policies and an unsustainable rate of monetary growth in these countries. It is interesting to note that all of these factors were already present when short-term capital initially moved to Southeast Asian countries. Therefore, one finds this after the fact analysis less convincing. On the other hand, economic history points to a different direction. It was the open interplay between "greed" and "fear" that was the primary cause for this phenomena. The history of international capital movements in the post second war era clearly demonstrates that greed was present when the short-term investors and hedge fund operators moved in with billions of dollars in countries whose economies were not yet ready to absorb such an enormous inflow of capital. When these fund managers and operators failed to foresee higher than competitive returns that they expected, some panicked. Fear of loss took over and everybody rushed to exit without any regard to the consequences of their actions on the countries currency values, price levels, overall economies, and the livelihoods of their poor and destitute. In the severity of its impact on some segments of the countries' societies, the flight of capital demonstrated an attitude of a heartless moneylender who lends funds to a pauper for buying warm clothes, only to take them back during a severe snowstorm.

Could this financial crisis have been avoided? The answer, according to

Islamic Economics, is a strong yes. According to the principles that Islam promulgates, the receiving countries could have protected themselves from this financial calamity by strictly adhering to an interest-free, equity based, profit sharing arrangement. In addition, in the Islamic economic system, such short term financial crises are not allowed to occur because the system avoids unstable, short-term investments. It is based on the recognition that short term capital is inherently unstable because the accumulation and management of such-capital is primarily motivated by two factors. The first is greed, which manifests itself in terms of the desire to earn the highest possible risk free return, coupled with the second factor, which is the constant fear of being wrong in the evaluation of these risks. According to Islamic economic prescription, these recurrent financial crises caused by the interaction of greed and fear can be broken only if the entire financial system is overhauled to exclude the promise of a return on riskless investment and to include an uncertain return on capital, on the basis of sharing risk in the long run.

Recognizing its role as an organization dedicated to promoting Islamic values as well as solutions to all comprehensive socio-economic problems within an Islamic perspective, the Islamic Society of North America organized this conference on Islamic Banking and Finance.The overall theme of the conference was focused on practical and theoretical aspects of banking and finance. This volume presents the major keynote address, ten selected papers and a review essay within four broad categories. The first category includes the keynote address by prof Khurshid Ahmad, Saleh Malaika's overview of Islamic Banking: and my paper on the Institutional Framework of Islamic Economics and Finance, as well as a review essay on the recently published book on Islamic Law and Finance by Vogel and Hayes.

In his keynote address professor Khurshid Ahmad presents a comprehensive historical overview of the entire Islamic Banking and finance system with the passion, the zeal and the commitment of a beliving academician. He provides justification for the Islamic banking model and elaborates on the potential of Islamic banking to meet the challenges of the 21st century. He forsees Islamic banking model to fulfill the task of devising and implementing an efficient and equitable monetary system. According to Professor Ahmad Islamic banking indusry is well placed to accomplish the challenges of the future by redirecting its lending activities from short-term financing to the long term investments.

The review essay of Frank Vogel and Samuel Hayes widely acclaimed book on Islamic Law and Finance sets the stage for a broad and comprehensive discussion of all legal theoretical and shariah based financial issues.

Vogel and Hayes emphasize both the conceptual as well as the practical policy oriented aspects of Islamic banking and finance. The review essay of their book is expected to provide the readers material for the appreciation of the relevance of major concepts, current issues and the challenges that Islamic banks are facing in their operation and product development. It is for these reasons that an unconventional approach has been followed in placing the review essay at the beginning of this book in the first category.

Saleh Malaika's paper traces the development of Islamic Banking through four phases: conceptualization, application, evaluation, and finally the current phase of product development.The paper foresees banking and the mode of Islamic financing as evolving into an industry with standards, systems, human resources, and regulations in order to establish a niche in the current competitive marketplace.

My paper emphasizes the macro aspects of Islamic economics as well as its micro applications to finance and banking. It demonstrates that at the macro economic institutional level, Islamic economics incorporates a freely competitive enterprise system that is organized within broad parameters of Islamic moral, social, and ethical values, as well as world view. At the micro level, the paper highlights the challenges that Muslim consumers confront in their attempt to implement Islamic financial strategy in North America.

The next groups of five short descriptive papers are devoted to various aspects of banking and insurance. Four of these attempt to explain and describe the operational structures of Islamic banks and the fifth analyses the prospect of Takaful in the U.S.A. Rafiq Bengali's paper explains the difference between Islamic and conventional banks and the manner in which these two types of institutions arrange for short, medium, and long term financing needs of its customers. In his presentation, Pervez Nasim focuses on various models of interest free home financing that Islamic banks use. He highlights the strengths and the weaknesses of each type. These types include lease financing, installments profit sharing, and rent to own financing. Imtiaz Ali's paper pursues the same theme within the framework of cooperative arrangement. The paper enumerates on the experience of cooperatives in Trinidad and Tobago in financing various business ventures. Said Zafar's paper on Islamic banking experience in Canada elaborates on the experience of Islamic housing cooperatives in that country. The last paper in this group by Omar Fisher provides an overview for the future of Takaful insurance in U.S.A within a historical as well as comparative perspective.

The last three academic papers provide an insightful, analytical and timely contribution to the two current areas of Islamic finance- home mortgage and capital markets; The paper on "Issues in Developing an Interest Free

Mortgage in the USA," by Abdullah Yavas analyzes the problem of mortgage financing within the framework of the economic practices, laws, and tax systems in the United States. It emphasizes the need for making interest free mortgage financing competitive by focusing on the tax and incentive implications of the Islamic mode of financing. Yavas draws from the perspective of Islamic analysis, consumer behavior, as well as, experience from Muslim countries, and concludes that for any interest free mortgage to be successful, it must strive to be competitive and financially attractive to potential homebuyers. The last two papers in this volume deal with the issues of securitization and development of fixed income securities within the profit and loss framework. Zamir Iqual in his paper on scope of asset securitization in "Islamic Banking" discusses the need for the fulfillment of marketability, negotiability and liquidity through the process of securitization. His analysis reveals that Islamic finance can achieve asset securitization in the area of leasing, commodities, equities, and trade and export receivables. The last comprehensive paper in this volume, by Fahim Khan, represents a significant and timely contribution. It reviews the existing conventional markets for fixed income instruments and provides a framework within Islamic law and finance to develop similar instruments. The advantages of such instruments for providing leverage and minimizing from operational risk are fully discussed and convincingly elaborated. The paper recognizes the existence of a great potential for the successful application of Islamic financial principles in the U.S. for Muslims and nón-Muslims alike. It appropriately concludes that once competitive Islamic financial instruments are developed and popularized, U.S. financial markets will easily match, if not replace the growing phenomena of international Islamic finance and capital markets.

—Imtiazuddin Ahmad

ISLAMIC FINANCE AND BANKING: THE CHALLENGE OF THE 21ST CENTURY

*Keynote Address by Prof Khurshid Ahmad**

The Islamic Society of North America and all the cosponsors deserve our thanks for taking this timely initiative to hold the First International Conference on *Islamic Finance and Banking*. As I have to cover a rather vast area within a short span of time, excuse me if I try to be rather short, yet precise. I propose to confine myself to essential points, and as such may not go into details.

Let me submit that in my view, Islamic Finance and Banking is no longer just a theory, a dream. In fact it is now a reality, albeit an emerging, evolving and fast growing reality. In view of their religious and ethical commitment, Muslims have never compromised on the concept of *Riba*. For 1200 years they developed and successfully managed a thriving economy on a Riba-free basis. They were a major actor in the arena of world economy.

Muslims constituted the bulk of what now goes as the Third World. The position of this Third World in the 18th century vis-à-vis the West was in no way inferior. They lost the game in the following centuries of industrialization and western imperialism. But the relative share of the Third World in world manufacturing output at the advent of the 19th century was three times higher than that of Europe and the per capita level of industrialization was comparable till 1800. The economies of the Muslim countries were, by and large, supported by a financial system that was not tainted with Riba.

* Professor Khurshid Ahmad, a former Federal Minister for Planning & Economic Development, Government of Pakistan (1978-79) and a Senator (1985-97), is presently Chairman, Institute of Policy Studies, Islamabad, Pakistan, and Chairman , The Islamic Foundation, Leicester, UK. He has authored or edited over three dozen books and was the recipient of the King Faisal International Prize for Service to Islam (1989), Islamic Development Bank Award on Islamic Economics (1988) and American Finance House Award for service to Islamic Economics and finance (1997).

Paul Kennedy gives a snap-shot view of the world from 1750 to 1900. A quick look will show that we are talking of economies at reasonable levels of sophistication:

*Relative Shares of World Manufacturing Output**

Region	country	Years				
		1750	**1800**	**1830**	**1860**	**1900**
Europe		23.2	28.1	34.2	53.2	62.0
	(Russia)	(5.0)	(5.6)	(5.6)	(7.0)	(8.8)
	(U.K)	(1.9)	(4.3)	(9.5)	(19.9)	(18.5)
USA		0.1	0.8	2.4	7.2	23.6
Third World		73.0	67.7	60.5	36.6	11.0
	India/Pakistan	(24.5)	(19.7)	(17.6)	(8.6)	(1.7)

Per Capita Levels of Industrialization (1750-1900)
(Relative to UK in 1900 = 100)

Region	Country	Years				
		1750	**1800**	**1830**	**1860**	**1900**
Europe		8	8	11	16	35
	(Russia)	(6)	(6)	(7)	(8)	(15)
	(UK)	(10)	(16)	(25)	(64)	(100)
USA		4	9	14	21	69
Third World		7	6	6	4	2
	(India/Pakistan)	(7)	(6)	(6)	(3)	(1)

The scenario materially changed in the following two centuries of Western domination. In 1800 Europe occupied or controlled 35 percent of the land surface of the world. In 1878 its control extended to 67 percent of the world and in 1914 it reached the high water mark of 84 percent. A new economic system was imposed on the world, an offspring of marriage between capitalism and imperialism.

The last two hundred years are also characterised by a global economic system based on *riba*. The kingpin of the post-industrial revolution financial system had been interest. Muslim countries were also overwhelmed and overtaken by this new economic order. Some Muslim intellectuals, Ulema,

* Source: *The Rise and Fall of Great Powers* by Paul Kennedy, Random House, New York,1987, p.149.

Fuqaha, and intellectuals did try to develop, at an academic level, a critique of interest as also of Capitalism and Imperialism as economic and political systems. They also came up with suggestions and proposals as to how an alternative system can be established. Maulana Abul A'la Mawdudi, Imam Mohammed Baqar Sadr, Dr Anwar Iqbal Qureshi, Dr Nijatullah Siddiqui, Dr Muhammed Uzair and Dr Ahmad al-Najjar were amongst the pioneers of this movement.[1] Yet their efforts remained theoretical exercises. It was only in the last forty years that material change has taken place and major developments have been taken in four directions.

First, at the academic level, professional economists and bankers have overtaken the field and tried to build on the foundations laid down by the ulema, fuqaha and intellectuals. Secondly, serious efforts at institutional level have been made to establish riba-free financial, investment and banking institutions. Thirdly, universities, research institutions, international professional organisations (including some Western universities and professional associations) have begun and developed academic, training and research programmes in different areas of Islamic economics, banking and finance and as such initiated a process of widening the academic horizon and making research inputs towards facing the problems that are bound to arise with the introduction of riba-free systems and instruments. Finally, at the state level initiatives began to be taken to switch over the national financial system from riba to riba-free basis. At least in Pakistan, Iran, Sudan and Malaysia such efforts began to take off. At the global level also the establishment of the Islamic Development Bank and its research institution, Islamic Research and Training Institute, represent major developments to establish a net work of financial arrangements and institutions within the Muslim World. That is why I regard the last forty years as a period of major break-through moving towads not only greater sophistication and professionalisation in the discipline but also transition from theoretical formulations towards practical experimentation.

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1. See: Abu A'la Mawdudi, *Sood* (Interest), Islamic Publications, Lahore, 1951; Mawdudi, *Ma'ashiyat-e-Islam* (Economics of Islam), Islamic Publications, Lahore, 1969, p.436; Muhammad Baqir al-Sadr *Iqtisaduna* (Our Economics), Dar al-Fiker, Beirut, 1968 (2 volumes) p.694; Baqir al-Sadr *al-Bank al-larabewi fil Islam* (Intrest-free Bank in Islam), Jami al-Naqi, Kuwait, 1974, p.208; Anwar Iqbal Qureshi, *Islam and the Theory of Interest*, Ashraf Publcations, Lahore, 1950; Mohammad Nejatullah Siddiqui, Ghair Sudi Bank kari (Banking without Interest), Islamic Publications, Lahore, 1969, p.224; Dr Muhammad Uzair, *An Outline of Interestless Banking*, Karachi, Dacca, Rehan Publications, 1955; Dr Ahmad al-Najjar, *Bank bila Fawaid Ka-istiratijiyah li'l-tanmiyah al-iqtisadiyah* (Bank without Interest as a Strategy for Economic Development), Jamiat al-Malik Abdul Aziz, Jeddah, 1972.

Very elementary efforts were made in Pakistan in 1950s, both in cooperative as well as commercial sectors.[2] In Egypt two pioneering experiments were made. First in the form of Mit-Ghamr Bank (1963-1967) combining the idea of German saving bank with the principles of rural financing within the framework of Islamic values. This was followed by the establishment of Nasr Social Bank in 1971-76, to help in particular the weaker sections of the society. In Malaysia a major break-through was achieved with the establishment of Tabung Haji (1963), a specialized financial institution to mobilize savings and enable Muslims to participate in investments, industry, commerce and plantation in accord with Islamic principles and also to provide for the protection, control and welfare of Muslims while on pilgrimage (Hajj) through various facilities and services of Tabung Haji. With a modest start with 1,281 depositors in 1963 and a total of M$ 46,600 in deposits by mid 1985 it arose to a million deposits with total deposits exceeding one billion Malaysian dollars.[3]

1975 stands out as a landmark in the emergence of contemporary Islamic Banking. The Islamic Development Bank was established at the Ummah level, with the full backing of the Islamic Foreign Ministers' Conference. Dubai Islamic Bank was also established in the same year. This was followed by an emerging stream of Islamic banks: 3 in 1977, 2 in 1978, 2 in 1979, 1 in 1980, 4 in 1981, 3 in 1982, 10 in 1983, 5 in 1984 and 1 in 1985. By 1985 there were 35. [4] The number of Islamic banks, financial and investment institutions, according to a survey by the International Association for Islamic Banks, is now over 200. Their deposits are over $ 80 billion, their assets around $ 200 billion and they are operating in some forty countries of the world, including a number of non-Muslim countries.

A new development in the field is represented by the emergence of what can be described as trans-national groups like the Dar al-Mal al-Islami and al-Barakah-Dallah Group. We also find that the traditional, western riba based banks are now beginning to take interest in interest-free banking. Around a dozen leading European and American banks and finance houses are now operating interest-free savings and investment programmes. Even Dow Jones are developing on Islamic Index to attract Muslim capital. We also find that the riba-free principle is being extended to the fields of insur-

2. See Sheikh Irshad Ahmad, *Interest Free Banking*, Karachi, Orient Press of Pakistan, 1951.

3. Ausaf Ahmad, "Evolution of Islamic Banking" in Khurshid Ahmad (ed.) *Elimination of Riba from the Economy*, Institute of Policy Studies, Islamabad, 1995, pp.350-54.

4. Ausaf Ahmad, *Development and Problems of Islamic Banks*, Jeddah, IRTI, IDB, 1987, Table 1, p.9.

ance (*takaful*), leasing *(ijara)* and real estate finance. New Islamic financial instruments are being developed and used successfully. Prof Rodey Wilson of Durham University, UK has recently prepared a study for the *Financial Times*, London which gives a fair review of the landscape of contemporary Islamic Banking as an emerging and expanding field.[5]

This being the situation, it is fair to claim that Islamic Banking is no longer a mere dream or just a theory; it is a reality. Yet I must add, a *reality* at a nascent stage. That is why I called it an emerging, evolving, and fast growing reality.

Three Major Models

Analysing this Islamic financial global landscape, one finds that these experiments can be grouped under three scenarios, each representing a distinct model:

First, in the private sector – there are banks, financial institutions, investment companies, leasing companies, mutual funds trying to operate without interest. They are primarily owned by private investors and entrepreneurs, although in respect of some there is a degree of financial participation by some governments or international financial institutions. In some countries special laws have been enacted to enable interest-free banks to operate effectively with necessary depositor security. Two major financial groups of Faisal-Daral Mal al-Islami and al-Barakah-Dhallah belong to this category.

Second, at least three countries have tried to make a beginning in the direction of developing a state sponsored process of elimination of riba from among the entire banking system. Instead of establishing interest-free banks in the private sector, the strategy was to first establish 'interest-free counters' within the system, and then extend the interest-free system to the whole banking sector, so as to operate on new principles under the protection of state policy and central bank guidelines. The objective remains to finally cleanse the whole economy of interest. Pakistan partially initiated the process in 1980 and moved towards total change in 1985 but I am sorry to say that the process was frustrated somewhere in the middle. Primarily because of lack of political will the new system could not be established and the process somewhat aborted. Iran and Sudan are still moving in that direction, with a long mileage yet to cover. They have not followed exactly the same routes yet the strategy of total and state-sponsored change is common. The aim is not just one or some Islamic banks at the micro level, but transformation of the entire financial and banking system and ultimately the whole economy so as

5. Rodney Wilson, *Islamic Finance*, Finance House, Financial Publishing, London, 1997.

to conform to Islamic norms.

Third, the model which Malaysia has introduced is a mix of the two. On the one hand they have established under the legal framework of the country a totally riba-free Islamic bank with a distinct law and identity and along with that on the other, they have created a mechanism through which any conventional bank could also have a riba free window within the system. Some fifty two conventional banks have opened such riba-free counters. In this system the two streams of riba-free and riba-based banking can somehow co-exist and compete with each other.

Presently the Islamic Ummah is trying to experiment with these three models.[6]

What is Islamic Banking?

Now is the time to pause for a moment and try to clearly identity what constitutes Islamic Banking.

First, let us start with a foundational concept. The concept and role of money is crucial to any financial system. In an Islamic system money is primarily and exclusively a measure of value, a means of exchange and a standard for deferred payment. But distinct from the ethos of Western economics and conventional banking, money is not regarded as a commodity in itself, to be bought, sold and used to beget money. As a logical consequence of that in an Islamic framework money has to operate through some real economic activity or service. It is a facilitator and an intermediary, not an active self-contained agent in itself. Capital is productive, not money per se. It is a means towards production, through creative entrepreneurial efforts. It is to be an instrument towards value-added through physical expansion of the economy. In other words real economic progress and development consist in expansion of the physical and human aggregates of the economy via creation of assets, products and services, and not merely in the form of fiduciary financial expansion. It is through such a generation of wealth that well-being takes place and the relationship between money-economy and physical-economy remains in real equilibrium. Wealth does not create islands of affluence in an ocean of poverty and deprivation. Money never becomes the objective, the hero of the cast. It remains an intermediary and an instrument for real productive effort, for asset creation, for value-added and for expansion of physical economic activity in a manner that benefits all sectors and participants in the economy.

The next basic point is that there are two methods or processes through

6. For details see: Ausaf Ali op.cit.: Rodey Wilson, *Islamic Finance*, op.cit.

which financial cooperation takes place. First is direct investment. That is people who have money in excess of their needs and people who have productive ideas and expertise — entrepreneurs, innovators, producers, workers, traders join hands to pool their resources for further production and exchange. Those with excess funds through direct investment provide others with these resources to move the wheels of productive machinery and trade processes. This is the oldest and one of the most common forms of productive cooperation between money and entrepreneurship.

But there is also a second process and that is through financial intermediation. Instead of direct investment there emerges a series of banks, financial institutions, mutual funds etc. which act as intermediaries between savers and producers. They are the intermediary institutions through which savings can be mobilized and canalized for investment. The emergence of such institutions has transformed the economic landscape. They have been able to mobilize savings on a vast scale and in an institutionalized manner and make them available for production and other uses. The economic explosion of our times has been financed by this process. That is a very genuine role of banking and financial institutions. In principle direct investment as well financial intermediation are accepted as part of the Islamic framework.

But the crucial point is that whether it is direct investment or financial intermediation, there cannot be a fixed predetermined return on capital, loanable funds or credits. That does not mean that Islam stands for zero rate of interest. That is where some confusion persists. Islam does not deny a return on capital. It holds that capital is productive, as it leads to greater value added, and as such is entitled to a share from what it is instrumental in producing. There has to be a reward for capital. That is just and reasonable. But what Islam challenges is that capital or money or loanable funds have no right to an *assured reward* without sharing the risks of enterprise or project. It has to be a *variable return* based on actual performance of the project, enterprise, or the economy as a whole. Islam prohibits a reward without sharing risks or having a stake in the economic venture. That is the basic premise. So Islam says that if you want to give money to some one by way of a loan, to help him in need, you go for *qard-e-hasan*, where you are assured of your principal amount, but no increase on that. But if you are interested in a return, it has to go with risk-sharing. Reward and risk must go together. Interest is prohibited in all its forms, whether it is simple or compound, low rate or high rate, personal or institutional, private or public, consumption loan or productive investment — whatever be the category, any predetermined, fixed increase without sharing the risks of the project or

enterprise is riba and is prohibited. It is only the principal amount that is justified in loan transactions. But if you want to share the fruits and the rewards, and sky's the limit, that has to be on the basis of sharing the risk as well as sharing the reward. Otherwise it is exploitation and zulm, for one or the other, the lender or the creditor.

Let me sum up by submitting that in an Islamic framework there is room for *qard-e-hasan* where the principal is guaranteed, but there is no increase on that; as also for investment where return is justified but not in a predetermined form for one party, an *ex ante* assured return, but return for both based on real performance of the project i.e. *ex post facto*. That is just for both the parties.

Major Characteristics of Islamic Banking

Now we are in a position to spell out some of the major characteristics of the Islamic system of banking and finance. In my view five such characters deserve special mention:

First, Islamic finance stands for a system of equity-sharing and stake-taking. It operates on the principle of a variable return based on actual productivity and performance of the projects, specific or general, individual or institutional, private or public. Economic cooperation may assume as many forms as may be desired, both at micro and/or macro levels but the principle remains one of the equity and reward sharing and not of simple loan-interest relationship as in capitalism.

Secondly, a very crucial point relates to the whole vision of an Islamic economy. Islamic banking, as part of that vision represents a revolutionary departure from the conventional system. Islam wants the entire economy, all monetary and business dealings to move from a debt-based relationship, a debt-based economy to an equity-based and stake-taking economy. This is a revolutionary change as it calls for a new psychology and a new approach to the economy. It demands of all the actors within the economy to participate in the productive system and does not allow some to become a rentier class. This is distinct from the capitalistic approach where the whole economy is geared to making money by manipulating, managing and creating money and serving the interests of the rentier class. This is the root cause of exploitation in society and leads to grossly inequitable distribution of income and wealth in the economy.

Thirdly, Islamic approach is rooted in an ethical framework. As such it represents not only a shift from a debt-based economy to an equity-based economy, but also a movement from purely pecuniary and hedonistic profit-taking to a gainful economy that is also characterized by ethical norms and

social commitments. The ethical and social dimensions are crucial to all economic activities. There is a framework of *halal* (permissible and desirable) and *haram* (prohibited and undesirable) within which all economic activity, private and public, has to take place. The moral filter plays a crucial role in this system. And this filter operates at different levels, the conscience of the entrepreneur and the firm, the social climate of society, the legal framework, the supervisory and guiding role of the state and government. An activity which would be treated in the capitalistic system as productive because it is supposed to be satisfying *some* demand (e.g. pornography, gambling, prostitution, promotion of alcohol etc.) in the Islamic framework would be unacceptable. So ethical and social dimensions are integral to the Islamic economic approach. What are the objectives for which money is being acquired? Would that benefit individuals, the society and the humanity? Would it lead to establishment of a just, honourable, sustainable society, or result in exploitation, moral degeneration; social tensions and inequities? These questions are as relevant to decision-making as the financial profitability and economic viability of an activity or project. This is integral to the system, and not peripheral, or outside its pale, under the garb of value-neutrality.

Fourthly, Islamic finance and banking is entrepreneur-friendly. It is directed not towards mere financial expansion, but towards physical expansion of economic production and services. Money does not beget money. It is expected to finance talent, innovative spirit, new ideas, skills and opportunities. It is expected to result in greater decentralised economic activity and more equitable distribution of resources and wealth in the society. Conventional banking operates on the principle of financial collateral, with the result that concentration of wealth, income and power takes place on a vast scale. More money you have, more you can get. The emphasis shifts from viability of a project to the financial worth of the borrower. If you lack collateral, you stand a very poor chance to get loans irrespective of the viability or feasibility of the project and intrinsic trustworthiness of the person. The focus shifts altogether in an Islamic system. Collateral is not irrelevant, but is cut to size. Instead trustworthiness of the person and viability and usefulness of the project become more important. A more human approach is adopted which would result in greater distributive justice, equity, along with ensuring diffusion of resources in the society by going to the grass-roots, to the community development and individuals that go to make it. As such the small saver, investor, trader and producer become more important. It is community oriented and talent and entrepreneur-friendly.

Fifthly, the Islamic system is non-inflationary. This is a very important and fundamental characteristic of Islamic banking. Banker's almost uncon-

trolled powers to create credit is, among others, at the root of inflationary pressures. The de-linkage between financial expansion, money supply and physical expansion of the economy is a result of the financial and banking dynamics of our time. Islamic finance and banking restores equilibrium between these three variables. Stability in the value of money is a primary goal of an Islamic economy.[7] The measure of value must have a degree of stability, otherwise the economic fundamentals would get disturbed. The poor are the worst sufferers. That must be rectified. Islamic banking operates within limits that ensure stability in the value of money and an almost inflation-free economy.

In my view these five characteristics make the Islamic system of banking and finance distinct and unique. These are some of the major characteristics of Islamic banking and finance. While it is very clear that the system's distinctive feature is its interest-free character, it does not begin and end with that. There are other very crucial dimensions, like a positive vision of an equity-sharing and stake-taking economy, non-inflationary character and the ethical and social welfare dimensions in respect of savings and investment policies. Of course Islamic economic system has other dimensions that further strengthen and develop the egalitarian character and people-orientation of the system. Islamic banking and finance is a part of this ethical, humanitarian and justice-targeted socio-economic system

Why Islamic Banking?

In order to understand the real challenges of the 21st century, it is important to reflect for a while on some of the major changes that have taken place during the last two centuries and in the context of those transformations spell out the rationale and a role for Islamic banking.

The central issue is that the contemporary financial system is exploitative, unjust, discriminatory, unstable and crisis-generating. There is no denying some positive contributions that have been made by the banking and financial system towards the promotion of economic development and global capitalism. But when a balance sheet of achievements and failures is made, its failures outweigh and out-number. To claim that modern banking system has been an unmixed blessing is doing violence to facts and gruesome realities of world economy. As such it is worthwhile to reflect on the ethical as well as economic and social imperatives that call for a change from interest-based banking and financial system to an equity-based, stake-taking system where money is primarily a means and a measure, a servant and not the mas-

7. al-Qur'an: 6 : 152; 7 : 85; 11 : 84-85; 17 : 35; 26 : 181

ter: a system in which money does not beget money but money is used as a facilitator for greater production of goods and services resulting not merely in increasing the number of billionaires but producing real well-being for the people in the context of a developing, conserving and sustaining economy.

First and foremost as Muslims, for us prohibition of *riba* is a religious and moral imperative. Islam forbids interest in all its forms. The Qur'an uses the strongest terms for its prohibition. It challenges that those who are not prepared to leave dealing in interest, should be prepared for war from Allah and His messenger.[8] A Muslim society cannot exist what to say of prosper while it is at war with Allah and His messenger. There must be a cease-fire, before we can hope for Allah's blessings and bounty. But it is not Islam alone that has prohibited interest. All major religious and ethical systems have prohibited interest. So whether you look at Judaism, Christianity, Buddhism or Hinduism, interest was originally forbidden. Similarly all ethical and religious systems throughout history have forbidden it. Confucius, Socrates, Plato, Aristotle and all major medieval thinkers and theologians stood against interest and regarded it as a form of exploitation and tyranny (*zulm*). It was only during the last 200 years that legitimization of interest has taken place. For that matter one of the intellectual frauds perpetuated was to change the nomenclature: usury was replaced by 'interest'; as if usury was forbidden and not interest. Usury was exhorbitant/high interest rate, interest was supposed to be reasonable/low rate. But that is a myth.

If we look into the history of interest rates we will find that rates vary from 0.01% to 10,000%. Even today, while in Japan the going rate is 1%,

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8. al-Qur'an: 2 : 279. It is worth noting that the Qur'an condemns and prohibits *riba* (interest/usury) in most powerful terms and makes it very clear that one is entitled to the principal amount only, and nothing more. "Those who gorge themselves on riba behave but as he might behave whom Satan (Devil) has confounded with his touch; for they say "Buying and selling is but a kind of riba – while God has made buying and selling lawful and riba unlawful. Hence, whoever becomes aware of his Sustainer's admonition, thereupon desists (from riba), may keep his past gains, and it will be for God to judge him; but as for those who return to it – they are destined for the fire, therein to abide.

God deprives usurious gains of all blessings, whereas He blesses charitable deeds with manifold increase. And God does not love anyone who is stubbornly ingrate and persists in sinful ways....

O'you who have attained to faith! Remain conscious of God, and give up all outstanding gains from usury, if you are believers; for if you do not then know that you are at war with God and His Apostle. But if you repent, then you shall be entitled to the return of your principal (amount only); you will do no wrong and neither will you be wronged. If, however, (the debtor) is in difficult circumstances, (grant him) a delay until a time of ease: and it would be for your own good – if you but knew it – to remit (the debt entirely) by way of charity". (The Qur'an: 2 : 275-281).

in UK it is 8-10%, in Pakistan it is 20-24%, in Turkey over 80%. The plastic money that is increasingly being used all over the world carries a rate between 18 to 30%. Sidney Homer, in *A History of Interest Rates* sums up as follows his conclusion based on a survey of interest rates from Hammurabi's times to our own:

> "A bird's eye view of the history of interest rates will unsettle most preconceived ideas of what is a high rate or an average rate. Each generation tends to consider normal the range of interest rates with which it grew up; rates much higher suggest a crisis or seem extortionate, while rates much lower seem artificial or inadequate. Almost every generation is eventually shocked by the behaviour of interest rates because, in fact, market rates of interest in modern times have rarely been stable for long. Usually they are rising or falling to unexpected extremes. A student of the history of interest rates will not be surprised by volatility. His backward-looking knowledge will not tell him where interest rates will be in the future, but it will permit him to distinguish a truly unusual level of rates from a mere change.
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> "It is easy enough to cite seemingly fanciful interest rates. In fact, we do not have to look beyond our own century to find the highest and lowest rates in the entire span of this history: 10,000 percent high in Berlin; .o1 percent low in New York. Both rates were quoted on standard money-market credits under very unusual circumstances. This is a range of one million to one.
>
> "Hammurabi's legal limit of 20 percent per annum on loans in silver cannot be usefully compared with today's money-market interest rates. It was well above twentieth-century rates on prime business loans, savings bonds, savings deposits and the like, but was below 30-42 percent per annum legal limits and actual charges in many states of the United States for small personal loans. It will be very difficult, throughout this history, to compare like rates with like rates. There are more types and varieties of credit contracts in ancient and modern history than are dreamed of in the philosophy of the modern bond salesman."[9]

High or low rate is relative and irrelevant. To us as Muslims, and to all men of religion, it is illegitimate because it has been forbidden by God, the Sovereign and Law-Giver. It is against religion, against ethical values and

9. Sidney Homer, *A History of Interest Rates*, Rutgers University Press, New Brunswick, 2nd ed.,1977,p.6.

against the interests of humanity.

Having said so, the role of interest in economy and history also deserves to be examined on the economic and social criteria. On deeper reflection we are forced to conclude that interest has been one of the greatest menaces to humanity and economy. The glamour and glitter of the riba-based system is deceptive, not real. When we reflect on the economic theory and practice, particularly during the 19th and 20th centuries, we find some very disturbing trends. Some of the more important ones that deserve to be noted are as follows:

1. A systematic effort was made to drive a wedge between Economics and Ethics. Economics, which had always been a part of the overall ethical system of a society and civilizatifon was turned into an autonomous, self-contained disciple. In a craze for making it a 'positive science', it was delinked from values and socio-ethical norms on which the human society and civilization are based. It was ignored that even Adam Smith's *An Inquiry into the Wealth of Nations* (1776) was preceded by and rooted in the values he emphasised as cardinal to human situation in his *Theory of Moral Sentiments* (1759). "Self-interest" of *An Inquiry* was to go hand-in-hand with the concept of "prudence" spelled out in the *Theory of Moral Sentiments*. The ethical and moral roots of economics were severed. Its normative character sacrificed at the alter of so-called positivism. Consequently over the years economics became neutral towards values, amoral and consequently a dismal science not concerned with the ethical, social, humanitarian and environmental consequences of its concepts and policies. It was in this climate that God Mamon replaced God the Creator and Source of Guidance.
2. All religious and moral systems were man-centered in the sense that their ultimate objective was human well-being and establishment of justice among human beings in all walks of life, legal, political, social and economic. During these centuries of capitalist development the concepts of justice and equity were relegated to the oblivion. Initially economic effort and all wealth-generating activities were geared toward human well-being and equity. In fact 'wealth' and 'well-being' were almost synonymous. But in the modern phase 'wealth' and 'well-being' no longer meant the same thing. Gradually the concept of desirable and undesirable, even of productive and non-productive effort began to become irrelevant. 'Needs' were replaced by 'wants' tied to the purchasing power and the length of

the purse. Efficiency became the new catch word. People-centredness was replaced by wealth-centredness. 'Growth' became the rallying cry. 'Consumption must grow', 'production must grow', 'money must grow' became the new targets, irrespective of their consequences for ecology, conservation, distributive justice, grassroot well-being, and needs of society and posterity. Delinking of economics, investments and markets from justice and well-being lies at the root of the crisis of contemporary economies, local, national and global.

3. Monetization of the economy and the new role of interest and interest-based financial and banking institutions led to the establishment of a debt-based economy at national and global levels. A debt-based economy is bound to primary and predominantly serve the interests of only certain sections of the society, particularly the rentier classes. This system, over the years, leads to transfer of money, wealth and resources, from the many towards the few, from the poorer people, regions and countries, towards the richer people, regions and countries. It is the weak and the under-privileged who suffer; it is the powerful and the rich that prosper.
4. Finally a delinking takes place between the physical economy, the process of real asset-creation and value-addition in terms of more production of useful grounds and services on the one hand, and the monetary and financial expansion in the economy. Money no longer acts simply as a medium and a measure. It becomes a commodity and an object in its own right. The historical role of money as an intermediary for exchange (commodity-money-commodity - C-M-C) gets transformed into money-commodity-money (M-C-M) as Marx rightly identified. But that is not the end. In the contemporary phase of capitalist development the relationship between monetary and physical aggregate has totally changed. Now with the advent of future options, claims, derivatives and swaps, we have entered a world where even M-C-M is being rendered into M-M-M. According to the *World Economic Outlook* (IMF, Oct.1996, p.167) between 1986 and the end of 1994 the total notional principal of outstanding exchange-traded derivatives contracts, including interest rate futures and options, grew at an average rate of 40 percent from $ 0.6 trillion to $ 8.9 trillion. In the same period, annual turn over rose from $ 315 million contracts to $ 1,142 million contracts. The balloon of the financial economy is expanding at an alarming pace, via speculation, while the real economy is only

crawling at an uneasy pace. According to a recent study in foreign exchange markets financial derivatives are being exchanged at a rate of $ 1.2 trillion per day which is almost 50 times more than the daily physical international trade in goods and services. Similar is the situation in domestic economies of developed countries. Emphasis has shifted from asset-creation to making money by speculation in respect of claims over claims on assets. It is a make-believe world of financial players who are creaming off billions without contributing to real value-added in society and its spill-overs for human well-being.

Let me substantiate this situation by bringing a few quotations from some of the perceptive writers of our times:

John Gray, in his recent work *False Dawn: The Delusions of Capitalism* says:

"Most significantly, perhaps transactions in foreign exchange markets have now reached the astonishing sum of around $ 1.2 trillion a day - over fifty times the level of world trade. Around 95 percent of these transactions are speculative in nature, many using complex new derivative financial instruments based on futures and options. According to Michael Albert, 'the daily volume of transactions on the foreign exchange markets of the world holds some $ 900 billion - equal to France's *annual* GDP and some $ 200 million more than the total foreign currency reserves of the world's central banks'.

This *virtual* financial economy has a terrible potential for disrupting the underlying *real* economy as seen in the collapse in 1995 of Barings, Britain's oldest bank. Together with the accelerating development of global capital markets on which it stands, the virtual economy is a phenomenon unknown in the worlds economic history."[10]

Joe Roglay, a regular columnist of *The Financial Time*, London laments:[11]

"Liberal economists, promote marketisation of everything in sight adding to the sense of isolation that lurks within so many of us. Wealth

10. John Gray, False Dawn: *The Delusions of Capitalism*, Grunte Books, London, 1998, p.62.

11. "Time for Religions to Merge or Bust", *The Financial Times*, London, Dec. 20-21,1997.

creation is an amoral pursuit. It is what is done with wealth that matters. The population of billionaires is growing NOT all of them are generous to the poverty stricken.

"Only a belief in the spiritual self can soften the effects of this counter-human revolution. Alas, the defenders of the spirit are divided, sulking in their tents all over the place. Lacking cohesion, their strength once irresistible is draining away."

James Robertson, in a very perceptive study, *Future Wealth: A New Economics for the 21st Century* writes:

"Unlike both the capitalist and socialist versions of conventional economics, then, the 21st century economy must be based on recognition that people are moral beings whose freedom as such should not be narrowly bound by impersonal parameters laid down by market and state. The 21st century economy must accept, as an aspect of self-reliance, that people need space in which to exercise moral responsibility and choice in their economic lives. Measures designed to allow this free space to people as individuals, and also to groupings of people in local economies and national economies (especially in Third World), must be part of the new economic order...............

"The new economics must thus transcend the materialist assumptions of a conventional economics: that economic life is reducible to production and consumption; that wealth is a kind of product that has to be created before it can be consumed; and that wealth production and wealth consumption are successive stages in a linear process which converts resources into waste. It must reinterpret the manipulative concern of conventional economics with the production and distribution of wealth and the allocation of resources, into a developmental concern with how to enable people to meet their needs, develop themselves, and enhance the resources and qualities of the natural world. It must recognise that because human beings are moral beings the basic questions about economic life are moral questions........."[12]

James Robertson's observations on the role of interest and need for an interest-free economy also deserve to be noted:

12. James Robertson, *Future Wealth: A New Economics for the 21st Century*, Cassel Publications, London, 1990, pp.21-28.

"The pervasive role of interest in the economic system results in the systematic transfer of money from those who have less to those who have more. Again, this transfer of resources from poor to rich has been made shockingly clear by the Third World debt crisis. But it applies universally. It is partly because those who have more money to lend, get more in interest than those who have less; it is partly because those who have less, often have to borrow more; and it is partly because the cost of interest repayments now forms a substantial element in the cost of all goods and services, and the necessary goods and services looms much larger in the finances of the poor than of the rich.

"When we look at the money system that way and when we begin to think about how it should be redesigned to carry out its functions fairly and efficiently as part of an enabling and conserving economy, the arguments for an interest-free, inflation-free money system for the twenty-first century seem to be very strong." [13]

In a recent book, *One World Ready or Not: The Many Faces of Global Capitalism*, by William Greider observes that the rich nations of the world are acting like ancient usurers, lending money to the desperate poor on terms that cannot possibly be met and thus acquiring more and more control over the lives and assets of the poor. This is done mainly by commercial banks and private capital, but amplified and policed by the public lending institutions. The real profit on owning US bonds was 8.2% in the 1990s compared to 6.7% in the 1980s and 8.8% during the 1920s after which there was the great crash (1929). This exhorbitant return to rentier classes is to be seen in the context of the fact that across the twentieth century the average real return on holdings of long term bonds has been only 1.6%.[14] In other words creditors are at present receiving returns on their wealth 5 times the average level real economies are functioning.

Because of the interest-debt system, societies are being drowned in debts. In 1901 the total domestic debt of USA was only $ 1 billion; today it is over $ 4 trillion, with some $ 1.3 trillion in external debt. This is four thousand times increase over the century. So the richest country of the world is also the most indebted country, both domestically and internationally. According to recent studies in the U.S., every household's debt has reached an astonishing 91% of its disposable income compared with 65% in 1980. Debts contracted via plastic cards invite 18-30% rates of interest, punishing terms

13. ibid, pp. 130-131.
14. William Greider, *One World, Ready or Not*, Simon and Schuster, New York, 1997.

on all standards. Yet interest remains an innocent helper in the economy. The fact, however, is that a debt based economy is the most exploitative of them all — ultimately the system works against the common man, against the poor, and against the small entrepreneur, who go to make up the backbone of the economy. It is only the rentier class that gains. *The Economist* (London, May 30, 1998) comments editorially that in America there were only 13 billionaires in 1952, but in 1996/7 they have increased to 170. This is accompanied by the impoverishment of the poor and generation of ever-increasing inequalities in society.

The contemporary capitalist economies that have been reared on the foundations of interest and debt are very deceptive. Their apparent affluence conceals the miseries and deprivations they have generated. They are exploitative as well as unstable. The system is unjust and violative of all human values. Let me conclude this part by one more quote from James Robertson's latest work *Transforming Economic Life: A Millennial Challenge*:

> "Today's money and finance system is unfair, ecologically destructive and economically inefficient. The money-must-grow imperative drives production (and thus consumption) to higher than necessary levels. It skews economic effort towards money out of money, and against providing real services and goods.
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> "The transfer of revenue from poor people to rich people, from poor places to rich places, and from poor countries to rich countries by the money and finance system is systematic......One cause of the transfer of wealth from poor to rich is the way interest payments and receipts work through the economy. Dividing people into ten sections of equal size, a German study (Kennedy M. *Interest and Inflation Free Money: Creating an Exchange Medium that Works for Everybody and Protects the Earths*, New Society, Philadelphia, 1995) suggested that the effect of interest is that the richest section receive far more than it pays, the second richest receives a little more, and other eight receive less. The result is a substantial transfer of money from the poorest majority to the rich minority.
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> "The transfer of money from poorer to richer localities takes place through the automatic working of the national and international banking and financial networks......Third World debt in the 1980s and 1990s illustrate some of the causes and effects of systematic transfer of wealth from poorer to richer countries. International interest rates rose and so did the cost of imported know-how and technologies, while interna-

tional commodity prices fell. Through no fault of their own, indebted Third World countries found themselves with escalating debts, resulting from higher interest rates and composite prices to be paid and reduced foreign exchange. (Out of $ 1,200 billion owed by the Third World to the First World in 1990, only $ 400 billion constituted original borrowing. The rest consisted of accrued interest and capital liabilities). The response of the International Monetary Fund and the World Bank was to prescribe development that placed even greater emphasis on the export of commodities at low world prices....

"The money-must grow imperative is ecologically destructive..... (It) also results in a massive world-wide diversion of effort away from providing useful goods and services, into making money out of money. At least 95% of the billions of dollars transferred daily around the world are for purely financial transactions, unlinked to transactions in the real economy.

"People are increasingly experiencing the workings of the money, banking and finance system as unreal, incomprehensible, unaccountable, irresponsible, exploitative and out of control. Why should they lose their houses and their jobs as a result of financial decisions taken in distant parts of the world? Why should the national and international money and finance system involve the systematic transfer of wealth from poor people to rich people, and from poor countries to rich countries? Why should some one in Singapore be able to gamble on the Tokyo stock exchange and bring about the collapse of a bank in London? Why, when taking out pension, should people have to rely on advice corrupted by the self-interest of the advisers? Why do young people trading in derivatives in the City of London get annual bonuses larger than the whole annual budgets of primary schools? Do we have to have a money and financial system that works like this? Even the financier George Soros has said ("Capital Crimes", *Atlantic Monthly*, January,1997) that "the untrammelled intensification of laisser-faire capitalism and the extension of market values into all areas of life is endangering our open and democratic society. The main enemy of the open society, I believe, is no longer the Communist but the Capitalist threat." [15]

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15. James Robertson, *Transforming Economic Life: A Millennial Challeng*, Green Books, Devon, 1998, pp.51-54; George Soros has also developed his theme in his latest book *The Crisis of Global Capitalism*, Little, Brown & Co., London, 1998. He has come out with a frontal attack on 'Market Fundamentalism' and pleaded for the control and management of global financial flows.

The same author raises some other very pertinent questions in the context of the havoc wreaked by the interest-debt system and the possibilities that the next century may offer to restructure the financial and banking system of the world on alternate foundations – something Islamic banking is aiming to do and offering as an alternative, not only to the Muslim Ummah, but to the entire humanity. After re-affirming that "the effects of interest include transferring money from poor to rich, accelerating resource extraction and environmental damage, and diverting effort to making money out of money" Robertson raises the succinct questions:

"Why the process of issuing new money into the economy (i.e. credit creation) been delegated by governments to the banks, allowing them to profit from issuing it in the form of interest-bearing loans to their customers? Should governments not issue it directly themselves, as a component of a citizen's income?

"Would it be desirable and possible to limit the role of interest more drastically than that, for example by converting debt into equity throughout the economy? This would be in line with Islamic teaching, and with earlier Christian teaching, that usury is sin. Although the practical complications would make this a goal for the longer term, there are strong arguments for exploring it – the extent to which economic life world-wide now depend on ever-rising debt, the danger of economic collapse this entails, and the economic power now enjoyed by those who make money out of money rather than out of risk-bearing participation in useful enterprises.

"May there be a role for negative interest rates? These were proposed early this century by Silvio Gessel (from whom Keynes said the future would learn more than from Marx). The Austrian local currency experiments of 1930s required each currency note to be revalidated every month by attaching a special stamp costing 2% of its value. This stimulated the local economy by encouraging people to spend, not hoard, the local currency. Could other liquid financial assets, like current bank balances, be subject to negative interest rates? And would that be a good idea?....

"The shift to a people-centered, ecologically sustainable economic system will require corresponding shift in the services offered by conventional financial institutions and the further developments of new financial institutions. The latter include ethical, green and social banks,

micro-credit banks, credit unions and other grass-roots people's banks which provide credit for people and localities, unable to get it from conventional financial institutions." [16]

The Challenge of the 21st Century

In the light of above submissions let us clearly try to identify the real challenge humanity is facing at the close of the 20th and the advent of the 21st century. The challenge comes from the lop-sided financial and economic system into which humanity finds itself entrapped. The divorce between ethics and economics, between religion and society, between well-being and wealth is at the rot of this crisis. Another major challenge comes from the unguarded and extended role of money, from a means and a measure, to a commodity and a mysterious tool to beget more money without adding real value to the economy and without increasing the flow of useful goods and services. The disastrous consequences of this process towards driving whole societies and humanity at large into the hands of rentier classes, rendering vast majorities into a suffering mass. The result is increase in inequalities of income and wealth, huge transfer of resources from the many and the poor to the few and the rich, people and regions. This is the predicament of mankind, posing the greatest threat to the future. The interest-debt regime, with banks powers to create credit and the financial system's fiduciary expansion via futures and derivatives have increased manifold the exploitative character of the system as also made it extremely unstable and vulnerable.

Because of the role of interest, coupled with two distinct roles of banking and financial institutions, i.e. credit creation and derivatives, the world economy has reached a point where reform and restructuring have become unavoidable if total disaster is to be avoided. It is now being a question of survival for all. With over $ 65 trillion worth of derivatives circulating in a world whereas the combined GDP of all the 188 countries of the world is around $ 30 trillion only, where are we heading? And who are the major players in this world of financial speculation – almost 80% of this trade is in the hands of some two dozen big hanks and hedge houses! The threat is not only to economy, but to the very human society and civilization. The world economy is turning into a bubble and in this bubble, we are blowing more and more air only to keep it afloat. But how long can such bubble economies last? Ten years back Japanese economy was thriving and beginning to challenge the strongest economy of the world - the USA. Five years back the Japanese economy began to be described as a bubble economy. Now the bubble has burst and we are

16. James Robertson, ibid., pp. 57-58

seeing the consequences. What has happened to East Asian tigers? Even U.S. economy has its stakes. Last six months *The Economist* has twice expressed apprehension about the American economy is in danger of becoming a bubble economy. It is worthwhile that we open our eyes before a real crash takes place.[16A]

Our critique of interest and interest based banking is rooted in religious and moral premises, but it is also based on sound economic grounds. It is based on the demands of justice and the vision of an economy and society that caters for the well-being of *all* human beings and does not serve the interests of a few sharks only who live by preying on others. It is this vision of tomorrow that prompts us to move towards a new paradigm in economics and finance. It should be the concern of all human beings, in all parts of the world.

Because of globalisation, I am sure, no country is safe. While the 20th century will also be remembered for its great achievements in the fields of technology, science and informatics, which I don't deny, but the other side of the picture is also important. The forces of globalisation riding on the back of an exploitable system are becoming a threat to human society and values. The way out lies in a new approach . May I submit that the 21st century needs to address itself, from the economic viewpoint to at least five basic issues:

1. Need to bring about spiritual and moral re-awakening. Key lies in re-discovering the relationship between ethics and economics. This is the core issue. Ethics must not be confined to private conduct. It must be the pace-setter for individual character as well as group behaviour and socio-economic policies, at the local, national and global levels.
2. Move towards the establishment of a new world order, which is non-

16A. See a recent study of Peter Warburton, *Debt & Delusion*; Allen Lane, The Penguin Press, London,1999. The author comes to the eye-opening conclusion that "The promise of economic freedom held out by the dismantling of state ownership and control has been subverted by a personal and collective enslavement to debt. The parallel accumulation of financial wealth since the early 1980s has obscured this painful reality, but history warns that this situation is unsustainable. When stripped of their capital gains in equities and bonds, today's rising generations will appear overburdened by interest payments and debt repayments shcedules. Far from commencing a golden era of economic liberty and individual choice, millions are teetering on the edge of debt default and misery". He further says, " Apart from financial mismanagement, the only other essential ingredient of the west's predicament is the personal and collective addiction to debt. Indeed, the most significant aspect of financial mismanagement is the failure to confront debt addiction and warn of its consequences." He ends his Preface on a personal note worth reflecting upon: "When the opportunity arose to become free of debt in 1995, I took it and have not regrette it for one moment. I urge the readers of this book to take or make the opportunity to do likewise"(p.xi-xiii)

hegemonistic. What a shame that we talk of democracy and human rights, but the whole world system is based on hegemony of the powerful. Human rights and democracy are on lips. But what is the reality? Even one of the five veto-holding countries, can nullify a united resolution of the entire world. Look into any international organisation, the UN, the IMF and the World Bank, the WTO – everywhere we find hegemonistic trends shattering the dreams of democracy, power-sharing, participatory development, and co-operative relationships. Authentic Pluralism is the answer. Co-existence and not a clash of civilization is the need of the hour. Political, cultural and religious pluralism alone can lead us towards a world enjoying peace, affluence and justice.

3. Re-discovering the importance of physical and human capital formation and production of real goods and sevices. Physical and human dimensions of development deserve to be re-emphasized. The role of money has to be redefined and creation of physical aggregates — products and services that are useful for mankind be made the objective of all developmental effort. Untrammelled financial expansion has distorted the balance between monetary and real economic aggregates. The balance has to be restored by cutting financial economy to its real size; control credit creation and re-emphasize the development of local economies, public utilities, basic and consumption industries and effective distributive mechanism.
4. The need for equitable distribution of wealth and income at all the three levels that is: globally between countries, within each country and region, and at the level of individuals and households in every society, constitute the other basic challenge.
5. Market economy with social responsibility, moral commitment and positive role of the state to ensure fulfillment of social ideals and respect for the rules of the game. Laissez-faire and Command economies both have failed. To swing from one to the other is not the answer. It is the golden mean between market economy and social responsibility that can set the house of economy in order. Both go hand in hand to ensure freedom, prosperity and justice for all. As such a three sector economy – private, voluntary - altruistic and public sector with complete harmony amongst them may provide the organizational model for the 21st century.

Islamic Banks and the Future

Now if we reflect on these challenges, we find that Islamic banks and Islam-

ic economics are destined to play a very important role in the making of the future. This calls for a move from a debt-based economy — an unjust, exploitative and inequitable economy — towards a risk-sharing, stake-holding, participatory, community-oriented and people-friendly economy. Therein lies the key role that Islamic economics, Islamic financial institutions and the Muslim states can play in order to make the next century closer to our vision of a just and balanced society. That would also mean that the centrality of the productive criteria would have to be rediscovered. The financier should become a real investor, prepared to play a participatory role as investor along with the entrepreneur. In the western banking system, because of the collateral, the banker moves in only when he smells of prospects of bankruptcy. In an Islamic system, as the bank is also an investor it remains an active participant throughout. As such the bank would be concerned with and respond to early warning signals if things start going wrong. As mistakes can be set right before the rot goes too far. The system would be more stable and transparent. In such a system there would be an automatic adjustment of real assets and their financial counterparts. In the conventional banking system there is no such mechanism for adjustment. It is, therefore, hoped that banking that operates on Islamic principles will ensure growth with financial stability, equity and distributive justice. It could be sustainable both horizontally, that is at a particular time and vertically deep into the future. The ecological dimensions and the needs of the future generations would be equally taken care of.

The Task Ahead

The challenge is grave and multi-dimensional. The dangers and threats are too serious and alarming to be ignored. But the task is also gigantic. Islamic banking has offered a new approach. But the experience and contributions made so far are far short of what is required. As such it is important that a realistic assessment of what is to be done must be made. Man lives by hope. But man cannot live merely by hope! Effort, planning, training, management and creativity are all required to face the challenges ahead. What should Islamic banking do to initiate a global process deserves to be explored. Some tentative ideas are expressed below:

To recap the Islamic approach is rooted in a different vision of the economy: one that is equity-based as against a credit-based one. Not that there would not be a possibility for loan transactions - *Qard Hasan* exists at a certain level to meet genuine individual or business needs. But the structure of the economy would be on a very different foundation — capital and entrepreneurship would be co-participants, sharing the risks as well as the rewards of the enterprise.

Islam encourages trade and commerce. Profit is not only permissible, it is encouraged as a positive value. Instead of fixed rate of return geared to an *assumed* rate of profit, Islam provides for a *variable* rate of return based on *actual* profits. This is the basis on which Islam wants capital and entrepreneurship to co-operate and co-participate in the production process. Islamic societies were able to develop a number of financial instruments and institutions during the first millennium of Islamic history. Although the economic system is much more complex today, Islamic banking movement is an effort to develop an alternate system in the context of the contemporary economy.

However, it deserves to be noted that the abolition of interest is only one aspect of Islamic economics. Islam aims at establishing a just economic order, based on clearly spelled out economic rights and concepts of property, contracts, work and distribution of income and wealth. It stipulates a framework of values and disvalues, desirables and undesirables and hedges the market mechanism with a moral filter so as to ensure efficiency and equity in the processes of allocation of resources.

The role of state has also been clearly defined. Islamic state is neither a neutral police state of the *Laissez-faire* type nor a totalitarian state of the socialist order. There is a limited scope for intervention in order to achieve specific objectives. Islam also emphasizes the need for stabilization of prices and protection of the value of money. In such an economy, banks are not mere financial intermediaries but also play an active role in developing and maintaining a certain pattern of economy, serving certain socio-moral objectives as well. Of course, banks are not expected to act as charities, philanthropic organizations or mere "welfare institutions", but the welfare, equity and stability dimensions are as relevant to the banking ethos in an Islamic scheme as are considerations of security efficiency, optimality and profitability. Definitely there would be trade-offs. As such the objective is to achieve a balance between efficiency and equity, between profitability and welfare, and between expansion and stability. Traditional banking is also trying to discover the moral dimension in a limited sense. The whole movement towards ethical banking is an instance in point.[17] But that is something on the periphery – and not even the whole periphery. Ethics and social objectives are central to Islamic banking – and that is why Islamic banking is not mere interest-free banking. It is much more than that. It represents a new and vastly different vision of the whole economy.

The basic idea of Islamic banking is to devise an efficient and equitable

17. See James J.Lynch *Ethical Banking: Surviving in an Age of Default*, Macmillan, London, 1991.

system of profit-sharing (PLS). The *efficiency property* derives from its insistence on *the linkage between the financial and the real sectors of the economy*, while the *equity property* is based on *maximizing the rate of return on deposits*, depending on the length of the period for which they are held.

But to make Islamic banking efficient and equitable its profitability – that is, the difference between the rate of return on advances and the rate of return on the deposits (which is also referred to in the literature, as the 'spread') – should be maximized. Yet another requirement is that the risk element inherent in the bank's operation is minimized, and scrupulously managed.

The connection between the efficiency and the profitability properties is provided by the fact that, as established by many empirical studies, the level of economic activity is the most significant determinant of the growth of deposits and advances, and of the 'spread'. In other words, to maximize the profitability of the banking system, economic policy must aim at enhancing the growth rate of output and creation of effective demand. Whence follows that the Islamic banking, by strengthening the link between the financial and real sectors of the economy, also raises the potential level of social profitability as against that of traditional banks.

The link between the superior equity and efficiency of Islamic banking derives from the requirement that the profits (and the losses) made by such banks are shared in accord with moral (and binding) principles of justice and beneficence (*'adl wa ihsan*). Thus, given the normal operating expenses incurred by Islamic banks and the rate of return on their advances, the potential rate of return on deposits would be generally higher than that offered by the traditional banks.

The linkage between the riskiness, the efficiency, the equity, and the profitability of Islamic banking rests on its ability to devise an investment portfolio which, on the one hand, satisfies the preferences of the risk-averse investors and those of the risk takers (i.e. those who take no risk and those who can afford a lot of risk); while, on the other hand, it should reflect the state of economic activity in the society.

Apart from any considerations for efficiency, equity and profitability, there is the case for the PLS instruments because they seem to reflect most faithfully the principles of *Shari'ah*. Such instruments also set Islamic banking (based on equity-finance) apart from traditional banking (based on debt finance). In other words, the PLS instruments make the Islamic nature of banking most visible. The revolutionary potential this type of banking bears for the future is beginning to be realised by an increasing number of Western economists and bankers.

A study by the Development Centre of the OECD on *Arab and Islamic Banks* touches upon this aspect. The author, Ms. Traute Wohler-Scharf, says:

"If the South proposes now, with Islamic banking principles, a new concept of socio-economic interaction (profit-sharing systems, focus on small and medium-sized innovative entrepreneurs, with the major objective of economic asset creation, etc.), it would be a contribution to co-operation concepts so far mainly propounded by the countries of the industrialised world.

Islamic banking is trying to change the relationship between finance on one hand and industry and commerce on the other. This new relationship is the basis of the Islamic economic system being set up. Though Islamic principles have yet to be put to the test in the competitive environment of international finance, the two systems are similar in that they both strive for closer ties between financial intermediation and economic asset creation.

Islamic banks could make a useful contribution to economic growth and development, particularly in a situation of recession, stagflation and low growth levels, because the core of their operations is oriented towards productive investments. All countries, both in the North and in the South, need more venture capital. Loan capital is available, particularly in industrialised economies, but at the high interest rates. However, even medium-scale entrepreneurs there find it difficult to raise sufficient risk capital for expansion and innovation. This has acted as a brake on productivity and economic growth in the North.

Thus, practical and intermediate co-operation possibilities exist between Islamic banks and enterprises all over the world. The intermediate process remains to be fully developed".[18]

Professor John R. Presley and J.G. Sessions of Loughborough University (UK) have in the May 1994 issue of the journal of the Royal Economic Society of Britain, *The Economic Journal*, tried to examine this central contribution of Islamic principles of finance. The authors, after regretfully noting that the:

"Western economists have been somewhat remiss in the last decade in

18. Traute Wohlers-Scharf, *Arab and Islamic Banks*, new business partners for developing countries; OECD, Paris, 1983, p.95.

failing to recognise what has the appearance of a new paradigm in economics - that of Islamic economics."

they conclude:

"A *riba* contract creates an explicit mapping between the compensation and the input of capital...The prevalent method of *Mudarabah*-financing tries compensation on the outcome of the project. *Mudarabah* therefore allows the contract to control the managers' incentive to exert effort directly, since this effort affects the relationship between capital investment and the outcome of the project. Under a *Mudarabah* contract the manager is let free to choose the individually optimal level of investment in each state contingent on his contractually specified level of effort. Such a contract permits a mean-variance improvement in capital investment - average investment is increased whilst inefficiently large fluctuation around this level is reduced...We have shown that the use of the prevalent alternative method of financier remuneration (i.e. *Mudarabah*) will, under certain conditions, lead to an enhanced level of capital investment on account of the ability of *Mudarabah* to act as an efficient revelation device" [19]

Islamic banking, if properly developed on the fundamental principles expounded by Islam, is destined to play a crucial role in reconstructing the economy in the 21st century on very sound foundations. But let me say in all honesty that Islamic banking, despite a promising beginning, is only in its larval stage. The real concept in its all comprehensiveness is yet to be fully translated into reality. The movement has a long way to go to become truly representative of the original concept. The efforts that are being made with seriousness and dexterity to eliminate *riba* from financial dealings, however welcome, have a long mileage to achieve. It is a fact that these experiments are being made in a climate - both domestic and external - which is anything but congenial. The moral fibre of the society is weak. The legal framework is antagonistic. The tax system is partial towards the interest system and almost inimical to a profit-sharing system. The state of competition between the Islamic and traditional banking systems is such that most of the odds are against the Islamic system. In this context whatever progress has been made is path-breaking. Yet it deserves to be acknowledged that these efforts represent only first steps in the direction of Islamic banking. Present day interest

19. J.R.Presley and J.G.Sessions, "Islamic Economics: The Emergence of a New Paradigm", *The Economic Journal*, Vol.104, No.424, May 1994, p.595.

free banks have relied rather too heavily on those permissible instruments of financing which are closest to the traditional system like *Murabahah* (mark-up) and *Ijarah* (leasing) - Almost 80 to 90 percent lending has been done through these instruments. The real alternate instruments of *Mudarabah* (trustee-financing) and *Musharakah* (profit-sharing) have been resorted to only to a very limited extent. Other ethico-social objectives have also not received the importance they deserve. Greater success has been achieved in the field of deposit-mobilization, particularly many untapped sources have been drawn upon. But the socially beneficial and development and welfare oriented utilization of these resources has left much to be desired. Employment generation and flow of resources towards the lower and middle classes of the society, particularly in the rural sector, where great potential as well as the greatest needs exist, has not taken place. So is the question of efficient utilization of funds. That is why it would be unfair to judge the success or otherwise of the Islamic banking scheme mainly on the basis of the limited and partial experiment that is presently being made. The experiment is not even halfway through. The mileage yet to be covered is crucial. The distinctive character of the system is yet to unfold and take shape. Then and then alone the scope and extent of the experiment could be fully and realistically appreciated.

However, looking at the actual experience, at least in some countries, the rate of return offered by the Islamic banks has been generally lower than that offered by the traditional hanks before the Islamic banking was introduced.

The investment portfolio held by the Islamic banks has generally favoured trade-related over production-related activities, short-term profitability over long-term profitability, and private profitability over social profitability. The heavy concentration in few assets of short-term duration has typically lowered the stability of the Islamic bank's portfolios and has increased the degree of their risk.

In practice, there has been an overwhelming preference by the users of loanable funds for the mark-up instruments over the PLS instruments, which have been overshadowed in the bank's portfolios. The real rate of return (adjusted for the inflation rate) has been generally lower, if not negative, while that on the bank loan it is strictly positive.

In view of these challenges from within and the major difficulties and bottlenecks from without, the Islamic banks have to make a Herculean effort towards implementing Islamic financial norms in such a manner that efficiency, profitability and equity are achieved simultaneously.

It is also submitted that the system of auditing of bank accounts must be upgraded to determine their legitimate operating expenses and the monitor-

ing of the cases of bank default or other deviations from the norm. This should be an integral part of Islamic banking review (indeed, of any responsible banking). In other words, the information basis of Islamic banks must be widened and made readily available with the help of modern computer-based technologies - which allow the storage, the processing and the dissemination of relevant information in a very short time and at least cost. This is basic, because the information cost typically rises when Islamic banking is introduced. For instance, the depositors will have to evaluate the relative performance of competing banks to reach a decision about where to invest their funds. On the other hand, the bank will have to seek greater and timely information about the use of the funds it makes available to the entrepreneurs.

The cases of loan default must be dealt with severely in Islamic banks as they amount to *khiyanat* (deception and fraud), which is a great sin in Islam. In general, any misappropriation of bank funds should be declared a social crime.

To satisfy the equity requirement, the difference between the rate of return on bank deposits and that on bank advances should be as small as possible - making due allowance for the bank's operating expenses, as determined by authorized auditors.

The Islamic banks should evolve innovative portfolios to suit the risk preferences of different classes of savers. It would be morally indefensible to make all classes of savers to bear the same degree of risk - irrespective of their capacity to take risk (which depends on the size of their respective incomes, savings, etc.). The Islamic banks should also show enterprising spirit by funding projects of a longer-term nature and where the social profitability of investment is higher than their private profitability - which typically covers all areas where external economies are large (health, education, infra-structure investment, etc.).

To lower the incidence of risk and uncertainty, a system of deposit insurance may have to be instituted. On the side of bank advances, the legal structure governing private property rights should be clarified and strengthened. The evolution of effective supervisory mechanisms at different levels, horizontal and vertical, also pose a critical challenge that must be met unequivocally.

While the present writer firmly believes that the Islamic banking can come of age only in an economy and society that is committed to total Islamization and where real transformation is produced as a result of a comprehensive movement, consisting of Islamically oriented behaviour of the individual and socio-economic reforms based on Islamic values, he belongs

to that group of economists who regard the contemporary Islamic-banking movement, despite all its weaknesses, as a positive development which bears great promise for the future.

It should also be mentioned that despite fundamental differences with the traditional banking there is a vast area of co-operation between the two streams. After all venture capital has played a very important role in the development of the world economy. Investment banking has been an integral part of banking more prominently in the German and French traditions of banking.

Unit trusts and investment houses are operating as major financial institutions in the world today. IFC as against IMF and World Bank, has gone into equity financing as part of international developmental effort. I do not think Western bankers would be averse to the idea of developing new modes of co-operation with the Islamic banks and financial institutions if they are presented with economically viable projects. If Bosphores Bridge - a billion dollar project - could be financed through venture capital, why not hundreds of other projects? Once this new commonality of interest, based not on traditional 'interest' but some form of equity-sharing - is built, I am sure new avenues of co-operation can be explored. Huge untapped resources exist in the Muslim world and one of the reasons why they remain untapped is Muslims' reluctance to go for interest-based financial instruments and institutions. Recent surveys have shown that even in Saudi Arabia, between 40-60 percent of the households that have a relatively high per capita income do not have a bank account. A large number of those who keep deposits have refused to take interest.[20]

The situation is not different in other Muslim countries and even with the Muslim communities in many Western countries. This potential is yet to be tapped fully. Moreover, Islamic banking principles and instruments are not relevant to the Muslims only. They have universal applicability. Some recent trends in world capital movements show clear shift towards equity investment and venture capital. Net private capital flows (direct investment, net portfolio investment and other longer and short-term net investment flows to developing countries were \$10.1 billion on average during 1973-77, which increased to \$27.4 billion during 1978-82, and to \$117.8 billion during 1989-95. The actual figure for 1998 is \$ 155 billion. As against this, net official flows, mainly debts, were \$11.1 billion during 1973-77, \$23.4 bil-

20. See R.Wilson, *Banking and Finance in the Arab Middle East*, Macmillan, London, 1983; N.A.Sherbiny, *Oil and the Internationalization of Arab Banks*, Oxford, Institute of Energy Studies, 1985.

lion during 1978-82, declined to $16.4 billion, average during 1989-95.[21] If these trends provide some clue to the future, they suggest greater scope for equity-investment in the coming decades.

21. *International Capital Markets: Developments, Prospects and Key Policy Issues* by Takatoshi Itu and David Folkerts-Landau., IMF, Washington, September 1996, pp.5-6. The figure for 1998 is from an article of Joseph Steglitz, Chief Economistand Senior Vice President of World Bank, originally published in *International Herald Tribune* ('Dawn' May 1, 1999).

Review Essay

ISLAMIC LAW AND FINANCE RELIGION, RISK, AND RETURN

Arab and Islamic Law Series
Frank E. Vogel and Samuel L. Hayes, III
Kluwer Law International, The Hague
1988, xv+330pp.

By
Imtiazuddin Ahmad *

Muslim scholars as well as laymen will find this book by two Harvard professors to be a refreshing departure from the typical Orientalist distortion of the message of Islam. This book on Islamic banking and finance is genuinely credible, timely, scholarly, and insightful. It is timely because it is published at a time when the Islamic banking and finance industry is faced with a myriad of challenges and competitive pressures from rapid introduction of new products and procedures by financial institutions all over the world. The book addresses these challenges head on and proposes a variety of solutions that call for a thorough and thoughtful analysis and response from Muslim scholars. The book is scholarly and insightful because it does not accept different views and interpretations of Islamic shariah scholars on the surface. It goes deep into the original sources of the Qur'an and Sunnah and the various interpretations of the Fuqaha. It engages in analytical discourse and discussions in order to explore the premises and the rationale of different controversial issues that they represent. The book is interpretative and discusses the applications of these views in the modern context. Finally, it makes a variety of recommendations on innovative products that Islamic financial institutions can use.

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The book is divided into three parts. Part one, the largest part of the book is written by Frank Vogel. In this section of the book Vogel carries out a comprehensive and comparative description of all those components of Islamic law that are relevant to finance. In its comprehensive nature and insightful discussions, part one constitutes the most challenging component of the book. Part two is written by Samuel Hayes. In this part, Professor Hayes conducts a detailed analysis of the various concepts, theories, and practices of modern financial system with a view to examine their relevance to Islamic finance. Part three is co-authored. It draws from part one and part two and in keeping with the case study tradition of Harvard's School of Business, it provides a number of illustrative case studies for testing the application of innovative financial contracts and products.

The discussion in part one is divided into five chapters, from chapters two through six. Since each chapter represents a new and different subject and for the understanding of the chapter that follows one needs to be familiar with the contents, the interpretative analysis and the discussion of the previous chapter, I have chosen to summarize and review each chapter in the same order as they are written.

Chapter one introduces the reader to the subject of Islamic Banking and Finance. It highlights some of the differences and similarities in the operational mode of Islamic and conventional banks, describes the history and growth of Islamic banks, discusses the impact of governments and religious scholars on their operation and product development and finally it outlines the plan of the book. The most significant part of this chapter includes the identification of various impediments to the future growth of Islamic banking in the modern competitive economic environment. These impediments include, lack of liquidity, limited products, cumbersome transactional arrangements, and lack of risk management instruments and technique.

Chapter two views Islamic finance as the application of Islamic law. It clarifies subjects such as the distinction between shariah- the divine revealed law, and fiqh- the sum of scholarly efforts to understand and apply the divine law. It elaborates the relevance of the religious laws to modern banking and points out the difficulties in the application of these laws to modern banking. It then explains the four methods of elaborating the law: interpretation, choice, necessity, and artifice. Vogel provides examples of the way these methods are viewed in the evaluation of some financial practices by the four schools of jurisprudence. In discussing the manner in which some of the new and modern financial practices and products are evaluated for adoption by Islamic banks, Vogel notes that a clear departure from old rules is extremely rare. Scholars rarely invent new terms, alter the definition of old ones or

introduce new legal constructions or criticize the methods of thought processes of the old scholars. Also he correctly observes that in Islamic finance, ijtihad has not usually been employed for fresh inventions but for evaluating and modifying existing conventional financial or banking practices. In my opinion, Vogel's recommendation for ijma and active ijtihad both needed to produce uniform opinions on various controversial financial issues, is quite timely and appropriate.

Chapter three concentrates on the presentation of all vital Qur'anic verses and ahadith on commerce and contracts. The discussion on the distinction between various kinds of riba and trade leads Vogel to raise probing questions such as, what sort of increase or inequality of exchange transforms lawful commercial gain into condemned usury despite both parties ready consent? In what circumstance does the desire for gain become perverted and corrupt? According to him, the answer to these questions has been complex and has often led to controversial interpretations. Chapter three also provides grounds for comparative superiority of the two basic tenets of Islamic law. The first relates to the conception and endowment of property as God created and God-given, thus making property sacrosanct and virtually transcendent. This construction according to the author differs radically from the Western concept of property's worth which is solely derived from its' utility and is often arbitrarily defined in the legal context. The second major tenet of Islamic law applies to the sanctity that it accords to the contract as a moral and legal means to gain property. Here Vogel is impressed with the strikingly liberal interpretation of Islamic law in recognizing gain through trade - the issue that has challenged the thinking of ethicist economists and legal experts for ages. This liberal endorsement according to him has, however been restricted to a degree by prohibition on riba, maysir, and gharar.

Here it is important to point-out, that these and other similar limitations in the area of finance and/or other spheres of human endeavor define what Islam calls Hudodul Allah-the limits or boundaries erected by the Devine Power. The desire and the commitment to adhere strictly to these Divinely defined parameters for human actions often explains the very cautious approach that most Muslim Scholars use in the interpretation of the Quran and the Sunnah.

In chapter four on Islamic law, usury, risk and property, Vogel engages in the core conceptual and deeply investigative discussion. He explores not only the complex legal, economic, and commercial aspects of the concepts of interest, risk, and property, but also attempts to summarize the rationale behind various limitations and prohibitions that Islam places on a number

of legal transactions. He provides an insightful and rational explanation for the major issue of riba in Islam. It is viewed as an excess or delay in exchange of certain types of property whereas profits are distinguished from riba on the basis of risk. When one party escapes risk all together, profits come under intensive scrutiny for riba.

Further discussion in this chapter revolves primarily around the justification of ban on interest in classical fiqah literature and the role of gharar in illigitimizing various commercial transactions. Vogel identifies a total of five reasons for the prohibition of various riba based transactions. These include: (1) mathematical equivalency, (2) avoiding commercial exploitation, (3) minimizing commerce in currency and foodstuffs, (4) linking lawfulness of gains to risk taking, and (5) using money and markets to allocate and moderate risks. When reviewed, in the modern financial context, he finds none of these explanations to provide satisfactory and consistent answers to a myriad of financial transactions. Another approach to discover consistent explanations appear to be Islamic financial and commercial law's concern to protect the buyer and the emphasis of the law to make certain that if risk is shifted from one party to the other, the party assuming the risk is adequately compensated.

In the last part of the chapter, the author engages in a discussion of the controversial issue of gharar. According to the author, Ibn Taymiyyah is the only scholar who in his liberal interpretation draws apart from nearly all classical scholars who in varying degrees use ignorance, nonexistence, and the absence of calculable risk as the touchstone of gharar. If gharar is equated with maysir and interpretated as pure deception or closely resembling pure speculation and gambling then a great deal of modern transactions will become acceptable in Islamic Finance. Furthermore, the Hanbali and Maliki's allowance of sales of absent or even nonexistent goods with clear description - the transactions which are quite common in numerous financial contracts-would certainly facilitate the development of competitive new products in the field of Islamic finance.

In chapter five Vogel describes the Islamic law of contract in a general form as a contract of sale (bay') and then provides a perceptive interpretative analysis of the specific contracts in the context of the modern use and applications by Islamic financial institutions. In its general application, although he supports ibn Taymiyyah's position with respect to the validity of all contracts until shown to conflict with the Qur'an and Sunnah, he feels that the mechanics of Islamic legal method still inhibits innovation. Despite this limitation, classical legal scholars have introduced some of the innovative contracts with modern applications. These contracts include: (1) salam- a con-

tract by which fungible goods are purchased for delivery at a later date with payment made in advance, (2) istisna- a commission manufacture contract, (3) arbun- an option contract by which a buyer makes a non-refundable deposit against the price reserving the right to confirm or rescind the sale, and (4) ijara- sale of usurfruct covering both hire of persons and lease of property. In addition to these contracts, Vogel also provides a succint explanation of sharika, mudaraba, and murabaha contracts. He clearly identifies three principles that are basic to all partnerships: (1) contracts are revocable at will, (2) losses fall solely on capital, and (3) profits must be shared by percentage and not in fixed terms. On the basis of its superior characteristics Vogel correctly describes, the partnership contract as the most fertile for modern Islamic banking and finance. While highlighting the distinguishing characteristics of Islamic law of contracts, Vogel also identifies a set of four principles that are derived on the basis of induction from a great many fuqaha opinions and rulings. These include: (1) the non-binding character of many basic contracts, (2) a dual scheme for allocating risk of loss, (3) the prohibition of sale of debt for debt, and (4) the non-binding nature of the promise. Of these four principles, he finds the last two to be uniquely important in their implications for the development of the principles for modern Islamic banking.

The discussion of rules concerning delay in payment and in performance or what Fuqaha call, sale of Dayn for Dayn, constitutes the most important critically challenging and controversial part of the entire chapter. Vogel notes that in order to avoid riba and gharar, fuqaha scholars have reached ijmaa on a maxim, which forbids the sale of "al-kali-bi-al-kali" meaning exchange of two things both delayed for the exchange of a delayed "nasi'a" countervalue for another countervalue. This ban on the sale of debt for debt carries significant implications in finance and affects a great deal of financial contracts in today's' economic world. On the basis of a strict application of this maxim on modern finance, all future contracts, all promissory deals, all options, derivatives, sale of guarantees, liabilities, damages to third parties become illegal according to Islamic financial law. In this context, Vogel recognizes a great deal of variation in different scholarly interpretations of this principle on a variety of seemingly similar financial transactions. According to him, ibn Taymiyyah appears to be the only scholar who sought to question the invincibility of this maxim. In view of the extremely restrictive interpretation that hampers Islamic financial institution's efforts to offer competitively superior products, Vogel strongly urges the scholars in Islamic finance to redirect their efforts both to a reinterpretation of this principle as well as development of Islamically viable new financial products that are designed

in accordance with this principle.

In order to familiarize the reader with the modus operandi of the current Islamic financial institutions, Vogel pursues five main topics in chapter six. These include: (1) basic model and theory for an Islamic financial institution, (2) Islamic contracts used in Islamic finance, (3) insurance, (4) the prospects for the development and use of Islamically valid derivatives, and finally (5) investment securities and their negotiability under Islamic law. In the discussion of these subjects, he identifies a number of critical issues such as, (1) the problem in managing deposits, (2) the establishment of proper relationship between management, shareholders, different types of depositors, and (3) determination of returns and risk for each category of investors. He also stresses the tendency for the Islamic banks to avoid risk and to rely heavily on murabaha. This heavy reliance on short-term minimum risk strategy has recently caused a great deal of concern among scholars of Islamic finance. The Islamic financial contracts that the author examines here in detail are: (1) mudaraba- a share contract, (2) bai Muajjel, or credit sale with a delayed payment at a higher price, (3) murabaha- a sale with markup, (4) ijara, or lease, (5) salam, or advance purchase, (6) istisna, or commissioned manufacture, (7) jiala, or reward, and (8) tamin, or insurance. Other forms of contract such as ina - sale on cash and buyback on installments, musharaka- more than one party contributing both capital and management are presented in chapter seven.

The most perceptive and controversial discussion in chapters six is focused on the prospects for Islamically valid derivatives. Vogel provides a basis for the development of derivatives in Islamic finance on two conditional Islamic contracts: khayard - shared or stipulated options, and arbun - down payments. Of these two contracts, he finds the arbun to be closely analogous to the pure call option. It is also the one, which is currently drawing a wider discussion in the literature on Islamic finance

In the concluding part of chapter six, he analyzes legal issues related to securitization and negotiability as well as the trading of financial instruments and products in the secondary market. Since Islamic financial law considers preferred stock, forward contracts, currency contracts and most options unlawful and often questionable, he recommends designing muqarada bond which resembles a modern revenue bond with profits split according to an agreed upon percentage.

Recognizing, Islamic law's prohibition of trading in goods until they are first owned by and in the physical possession of the seller as a severe restriction on the development of secondary market instruments, Professor Hayes in chapter seven provides a review of various contracts with a potential for

further development. In chapters eight and nine, he engages in a discussion of the modern financial theory of options, capital structure, and equity, with a view to provide background for the development of derivative in Islamic finance. His analysis of the cost of capital and asset pricing models implicitly assumes an annualized rate similar to the interest rate in modern finance. He also states that out of necessity, Islamic businesses should (and do), seek leverage in the capital structure for many of the same reasons that propel financial choices among conventional Western firms.

In my opinion, this conclusion as well as the calculation of the cost of capital does not quite fit in an Islamic framework of finance for two reasons. First, in the absence of an interest rate variable, the cost of capital calculation within an Islamic framework remains imprecise and inaccurate. Secondly, in view of strictly assets based financing requirements in Islamic finance, efforts to develop debt instruments will always remain limited and questionable. As far as the development of derivatives is concerned, although salam, istisna, arbun, khayr ul shart contracts have been mentioned as providing a basis for the development of these financial derivatives, this endeavor also remains controversial and questionable in the literature on Islamic Finance. Recent attempts by some scholars in this direction still remain unacceptable by a great majority of Islamic scholars.

The final chapter in this book on innovations in Islamic financial products builds on earlier discussion and generates suggestion for the design of various innovative products. The authors present these innovative ideas within the framework of concrete case studies, which address the need of both capital users as well as capital providers. Cases, involving risk management devices, marketable securities, account receivable financing, preferred stock, and future markets, are developed and explained.

The need of both capital users and providers are addressed within the framework of the following considerations. (1) Ownership in transit based on murabaha. Here Islamic banks coordinate their efforts through a single facility to share in murabaha type financing of international trade. (2) Cooperative non-bank factoring firm-This is set up on musharaka basis with private investors. It purchases goods from clients at a discount and resells them at full invoice on credit to customers. (3) Paralles salam contracts-These contracts are traded with the Islamic Clearinghouse which makes a market in the retail salam contracts. (4) The default penalty option-This contract if accepted might provide the equivalent of a call option. (5) Lease pools-These are organized musharaka with Islamic banks. Leases with common characteristics are pooled for liquidity. (6) Staged lease or lease pools. (7) Convertible lease-It is similar to a convertible bond. (8) Back to back istisna con-

tracts-These are designed to provide for a company's need to avoid paying full cost at the front of an expensive made to order product. (9) Options in istisna contracts - designed to cancel an order of new equipment that will take some time to produce. (10) Istisna contracts from manufacturing streams-to obtain financing for goods in process or to order without having to pay entire costs at front. (11) Fungible manufactures and options to find buyers for excess capacity or to lock in goods at attractive prices and also be able to escape from commitment if circumstances change, (12) jiala (reward)-to give employees incentives to meet specific performance goals.

These proposals in detail are intended to fulfill two specific objectives: to provide flexibility and efficiency in the financing of various products and processes as well as to assure conformity with the broad principles of Islamic finance. In view of severe limitations and the parameters in which various forms of legally allowed Islamic contracts are supposed to be implemented, it appears unlikely that unless a majority of Islamic scholars accept the liberal interpretations of the authors, all of these proposals will be favorably reviewed and implemented. Their universal acceptability will wait until the question of how far they remain within the structure and the spirit of Islamic law is resolved after a thorough discussion and evaluation by a group of experts in Islamic law as well as finance. Until experts arrive at a consensus, it is important for the general reader to realize that Islamic financial institutions can succeed in the modern world and compete effectively with the Western financial institutions only if they can demonstrate their superiority in theory and in practice. In order to,achieve this superiority they will need to have new and innovative marketable instruments, and organized financial markets. They will need instruments that can make future promises binding, and they will have to create tools and procedures for risk management. A "too cautious and literalist approach that clings to a narrow legalistic interpretation of the past", will make them lag behind in the modern world. On the other hand a pure pursuit of profitability and efficiency and a desire to cut corners in Islamic jusprudence in order to adopt all those financial innovations which have promoted risk management in today's world to the highest level of speculation and institutional gambling, will take them outside the bounds of their commitment to their faith.

The proposals of these well intentioned and visionary scholars should be viewed, discussed, scrutinized, and analyzed within the framework of the broad principles of Islamic finance that they fully recognize. These principles include: (1) Promotion of commerce and profit making activities and a guarantee of reward for both partners in business, (2) encouragement of entrepreneurship and the reward for labor and capital on the basis of their con-

tribution to the creation of wealth, (3) compensation for capital suppliers after results rather than prior to the outcome, (4) Assignment of loss fully and completely to capital providers, (5) a complete abolition of lending on interest and encouragement of the supplier of capital to earn profit appropriate to their commitment and exposure to risk and (6) Provision for different levels of profit on different degrees of exposure and the avoidance of risk shifting, gambling, or excessive speculation.

Viewed within this framework some of the proposals that Vogel and Hayes have designed, specifically those that involve procedures for shifting risk from one party to the other might be questionable. Also some Islamic scholars could question the entire frame of reference that the authors have used in designing these proposals. Some might ask, are these proposals designed to facilitate commerce and finance in today's complex and highly technical financial world within broad Islamic principles or the authors in their quest for making Islamic bank competitive with the conventional banks, inadvertently succumbed to a well intentioned yet dangerous exercise of reinterpreting various Islamic financial contracts in order to make them fit in the modern interest based system of finance? On the other hand, a number of other Muslim scholars might question the entire premises of Vogel and Hayes research on the grounds that Islamic interest free finance both at micro as well as macro levels constitutes an integral and comprehensive component of an independent values and faith system of Islam which stands entirely on its own principles. In their view, any attempt despite the sincerity and academic neutrality of the authors, to assimilate the two diametrically different and incompatible systems, is destined to fail.

In my view, these are genuine concerns. However, until a fully functioning Islamic State is established and both micro and macro level financial issues are resolved within the framework of ijtihad and ijmaa, Muslims who desire to conduct their financial affairs without violating the limits of the shariah have little choice but to accept micro level new financial products. The desire of a committed rational Muslim to promote his financial well being will always propel him to adopt genuine and credible products in Islamic banking and finance. Products that he is convinced are designed within the framework of the basic rules of Shariah.

When we view and evaluate Vogel and Hayes contribution within this framework we definitely find it timely, thought provoking, and significant. This book certainly presents a rare challenge as well as an opportunity for Islamic financial scholars. It deserves to be made a required reading for all those interested in this field.

Islamic Banking: Trends & Prospects

By
*Saleh J. Malaikah**

The first conference on Islamic banking in the U.S.A. was organized by ABANA two years ago and was a remarkable success. This conference is a continuation and covers all issues in more details. Al-Baraka group is and will continue supporting such conferences worldwide.

It is easy to look back at history and explain what has happened and why. But it' is extremely difficult to forecast what will happen. However, in order to assess any trends and prospects in Islamic Banking and Finance or any areas we need to understand the history and the major factors and its evolvement in order to portray its effects.

Various stages of development of Islamic Banking and Finance can be categorized in four phases:

Phase One: *Conceptualization*

In the Sixties and up to the early Seventies there was an elevation of consciousness on the need for an alternative to the interest-based banking. This was also in consequence to the end of the Western colonization era of many Islamic countries. Colonialism has left a banking industry basked on interest. Most central banks in the Islamic world have been modeled accordingly. After that era ended, there was a rising demand for a riba-free banking.

There wore many books, articles and various publications written on this issue. It was in-part of the call to go back to our spiritual roots on all aspects social, political, educational, cultural and economic.

Many scholars, scientists and theorists have dwelled on the balance between material and the spiritual, the earthly life and the hereafter and have concluded with the fundamental foundation of our creations on earth that

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is—development or cultivation of the earth—and that mankind was entrusted by Allah to carry this job, of course, abiding by Allah's orders in this world.

This issue is bigger than riba-based or not-riba based banking but it is a whole philosophy with guidelines that affect wealth and economics in the life of Muslims.

There is the concept of Zakat which requires a lecture by itself. Zakat has very fevorable consequences on the economic development as it motivates Muslims to invest long-term in start-up, in equity and higher risk ventures than fixed income investments where resources (human, material) are utilized impacting favorably on job creation and resourcos utilization. Zakat impacts favorably on the distribution of wealth.

There is the concept of Waqf. In the history of Islam Awqaf has played an important role in social development.

The concepts of Gharrar, Ghobn Jahala ae all issues which deal with unfair practices in economic relations and these are the foundation of modern Fiqh Al-Muamalat, Fiqh of Economic transactions. For example, monopoly was forbidden is Islam 14 centuries ago.

The return to our spirtual value system has culminated in the call to establish Islamic banks that are not interest-based and that adhere to the guidelines of Fiqh Al-Muamalat.

Phase Two: *Application and the Islamic Banking Model:*

The mid to the end of Seventies saw the rise of the first Islamic banks IDB then Dubai Islamic Bank followed by Dar Al-Mal Group and Al-Baraka.

These early models of Islamic banks evolved around the concepts of Musharaka, Mudaraba and the social role of Islamic banks. However, it was soon faced with many obstacles.

1) Regulatory
   - (a) As most central banks have only allowed regulations for commercial banking well rooted in the concept of intermediation' rather than Investment Management regulation.
   - (b) Human resources were mainly from conventional banking, therefore modeling the first few Islamic banks was confined to their expertise in conventional banking.
   - (c) Fiqh Al-Muamalat through rich in its historical resources was not

enriched in recent history to accommodate the new trends of economic transactions.

As a result of these obstacles the first Islamic banks emulated the conventional banks. However, this was a phase and with all its drawbacks it has achieved the following:

The birth of the concept and the discovery of the alternative has achieved the following.

It has attracted a wide segment of clients and established a niche market for itself.

It has formulated the macro-picture for accounting, organization, investment management and stemmed the evolvement of Islamic financing methods.

It has helped to establish the foundation for modern-era of economic fatwas, Fiqh of modern economic transactions as well as Shariah monitoring/control.

The third phase: ***The Evolution of Islamic Financing & Investment***

This mainly took place in the Eighties as the Islamic banks started to involve the economic activities. During this phase, various forms of financing and investment were crystallized and standardized.

These methods were:

Islamic financing methods:

- Murabaha 'installment sale'
- Ijara 'leasing'
- Salam & Istisnaa 'pre production finance'

Islamic investment methods:

- Mudaraba } All forms of partnerships
- Musharaka

Quasi (investment/finance) diminishing Musharaka

The emphasis in this phase was on the asset side of the balance sheet, that is the utilization of funds. On the liability side of the balance sheet only Mudaraba was used in the pooled investment accounts/schemes.

The Islamic banks have found Murabaha a natural solution to its short-term deposits. It was extremely difficult for Islamic banks to invest in long term/higher risk investments as it not only would create a mis-match between assets/liabilities but would represent a challenge in risk management especially with the human resources issue I mentioned earlier

This phase also saw the evolution of other basic forms of islamic financial institution: that is insurance and re-insurance, and leasing companies.

Although there was a concentration on Murabaha during this phase, there were may contributions to microfinance. The need to standardize fatwas; accounting standards and to develop products and research became apparent during the development of this phase.

The Fourth phase: ***can be termed as—Product Development***

Towards the end of the Eighties and during the Nineties, new financial products started to evolve. Standardization in Shariah issues started to take place. Accounting and audit standards evolved with the establishment of AAOIFI—Accounting and Audit Organization of Islamic Financial Institutions. More specialized form of Islamic financial institutions started to evolve particularly those in the areas of investment management and investment banking.

The whole concept of Islamic banking and finance broke loose of the experimentation tag. Western financial institutions started subsidiaries in islamic banking and divisions.

It is from this phase that one can build a forecast about the future of Islamic banks and on expectations about their growth.

The trends and prospects In order of their importance can be highlighted within the framework of the following future needs and developments.

Regulations:

The corner stone of the evolution of Islamic finance and banking will be regulatory. A regulatory framework that has to be comprehensive in addressing all requirements—for example, various types of financial institutions and investment banking, management, leasing, financial advisory, etc. In light of the Globalization trend that is taking place in the world today and the rising role of the world trade organization especially in the financial services agree-

ments the regulatory framework of any country will be its major part of establishing its competitiveness and its comparative advantages. All countries have to enhance their regulations across the board and particularly those related to financial institutions and supervisory and control measures. It will be a big mistake if the Islamic countries do not provide for well-built regulations for Islamic banking and finance. Islamic countries can excel in and establish a comparative advantage and later be able to export this model in entering other countries. It will be a big mistake to rely on the conventional model as the only alternative we should look at the experience and strength of the conventional model and enhance it to meet the Shariah guidelines and improve on it.

In my opinion Islamic countries as well as communities should institutionalize the concept of Zakat and Awqaf. Both are two important bodies in mobilizing wealth and one complimentary to Islamic financial institutions as a source of long term fund as well as a major player in economic development at large.

Insurance companies, another form of long term funds should be enhanced in terms of regulating cooperative insurance and other recent models that adhere to Shani'a need to be endorsed by the regulators.

Financial markets, financial instruments and products should also be well regulated. For Example:

Leasing Sukuks and leasing certificates
Mudaraba funds
Investment funds at large
(private equity funds, real estate funds, etc.)

Most secondary markets in the Islamic countries allow only two forms of financial instruments that is stocks and bonds. Some have allowed few derivatives. But if our own innovations and creations in islamic finance and banking were allowed an increased financial and economic activities will be witnessed.

Standardization of products. systems and Shariah:

The standardization is a trend that has gained momentum the last decade and will continue to move on.

Today there is a wide spread agreement on the financing and investing methods. Al-Baraka has introduced standard manuals on Murabaha and Ijara from all aspects particularly Shariah. It has standardized agreements and contracts. Most Islamic financial institutions are coming to consensus on these standards.

Al-Baraka is in the process of completing a set of manuals on all finance and investment methods.

This trend is also seen in AAOIFI Accounting and Audit Organization of Islamic Financial Institutions, which have produced 14 standards so far and will introduce (Inshallah) 4 more standards before the end of this year. The organization as well as the Islamic banking community is pushing the adaptation of those standards at the regulatory level as well. The organization is active in dialoguing with Basil committee and the International Accounting Standards Organization. AAOIFI should be supported and encouraged by all financial institutions.

Another important area is the standardization of economic Fatawas. Al-Baraka recognized the fact that in many ways the fatawas were meant to be flexible to suit the changing requirements while the fundamentals remains the same. Al-Baraka has sponsored an annual Fiqh symposium on Islamic banking and finance since 1982 that have yielded a wealth of fatawas that are published in books. Al-Baraka sponsored the development of computer program 'Fiqh Al Muamalat' a compilation of Fiqh of economic transaction in the past and recent history.

Al-Baraka has also been instrumental in establishing a unified Shariah Board in Fatawas for all its 30 subsidiaries in finance and banking.

The standardization in Fatawas is supposed to continue in the Islamic banking and finance. In the last annual meeting of IDB in Damascus it was agreed to commission AAOIFI with the task of building standards for fatwas—an objective that I personally encourage.

Also the human resources area will continue to be enhanced. The future will see more specialized Shariah scholars which have more technical involvement in the industry. One can also envision that if Shariah measures were adopted at the regulatory level like in Malaysia at the central bank, when a Shariah panel is available, in addition to the AAOIFI standards on Shariah we may see the formation of Shariah Audit firms rather than the current ad-hoc committees; it is also important to note that those committees were allowed to deal with the non-existence of Shariah standards.

The future for investment management/banks also appears to be quite promising. There will be more such institutions established than commercial banks in addition to other forms of financial institutions like the insurance leasing, asset management, etc.

In conclusion one can see Islamic banking and finance improve their current market-niche by evolving into an industry with standards, systems, human resources, and regulations. The task is not going to be easy, yet the challenges can be met with success.

Institutional Framework of Islamic Economics & Finance And the Challenges for its' Implementation in North America

By
Imtiazuddin Ahmad *

The Qur'an and the life of the Prophet (saw) provide us with irrefutable evidence to the fact that an individual occupies the primary focus of attention in Islamic world order. According to the Qur'an and the Sunnah, he holds the most privileged position in the universe.

A study of the life of the Prophet (saws) and his companions provides us with example of people who have lived their lives according to the Qur'anic profile. This profile clearly demonstrates that the Islamic economic man is a free and responsible individual. This individual is a rational economic player who has the capacity to distinguish between beneficial and harmful actions. He is efficient because he desires to maximize economic outcomes by expanding the least amount of effort to get the most from his environment. He is moral and accountable to Allah (swt) in accomplishing economic benefits. He avoids stepping on anyone else's toes. He does not exploit others, nor does he get exploited. His moral and spiritual horizon extends to the life hereafter. Therefore, his economic activities make him compete, as well as cooperate with others to get what he deserves from his work and natural abilities. He is productive. He acquires economic resources fairly and morally, through earnings from work, business enterprise, and capital gains, and inheritance. This inheritance has been accumuLated for

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him by his family, through frugal and fair means, and passed on to him legally. He fulfills his societal obligations by paying his dues, taxes, zakat, and sadaqat. He is a utility maximizer, who uses resources with full and complete freedom of enterprise. By doing so, he not only achieves the greatest satisfaction for himself, but he also creates employment and financial benefits for his family, community, and society at large.

In order to see what kind of an economic society will be created by a group of such individuals, let us generalize from this micro picture. It is clear that the combined actions of all such individuals will create an economic environment and a society with the following characteristics:

1. Individuals will rely primarily on the strength of their own character, skills, and resources in order to fulfill their obligations to Allah (swt), fellow Muslims, their families, their communities, and themselves. Indolence, laziness, dependency on others, and reliance on the government for charity will be disdained in such an economic environment charity, sadaqah, zakah, as well as all good Samaritan acts will only be used to provide the minimum necessities for those who are incapable of meeting their needs. Enterprise, endeavor, risk taking, leadership, and self sufficiency will be encouraged and promoted. Let us not forget that the Prophet (s.a.w) declared the upper, giving hand to be superior to the receiving one.
2. The government will act only as a protector of the community, a facilitator of private enterprise, and a provider of last resort. It will promote and facilitate business development by protecting its citizens from the intimidation and the coercion of the privileged and the strong.
3. Private ownership of the means of production will be the norm in a society of these individuals. Pursuit of material and spiritual progress and contributions to economic progress will be acclaimed as commendable objectives.

The state's responsibility will be confined only to an effective enforcement of laws in order to preserve free trade, eliminate monopolies, and stop accumulation of economic power in the hands of a few special groups.

This profile of the institutional framework of an Islamic economy, clearly demonstrates that extensive reliance on the public sector for economic development is inconsistent with the broad moral, ethical, and economic values of Islam. If public ownership of the means of production was a desirable economic strategy, the Prophet could have appropriated private lands

and businesses in the name of the Islamic State. He could have appointed some of his companions as supervisors and managers who would have managed these businesses in an outstanding manner. Despite the fact that the exemplary piety and character of these companions was matched with equally strong management skills, the Prophet (saws) refrained from such an act. Why? Because it would have been unfair, unjustified, and completely against the Islamic spirit of free enterprise. The fact of the matter is that the Prophet did not even allow any restriction on the size of holdings or on any other business. He even refused to interfere in the markets during the time of rising prices.

This background provides Muslims justifications to organize their personal economic living as well as their national economies exclusively on the principles of free market oriented private enterprise. Furthermore, in order to unleash the productive economic power that is needed for a sustained economic growth countries will need to open up their markets, promote free enterprise and competition allocate a substantial part of their resources for education. This investment in human capital will go a long way in producing honest, God fearing conscientious and economically productive individuals who can build Islamic states that can serve as role models for the entire humanity.

Islam's commitment to individual liberties and to economic freedom is a hallmark of the relevance of its overall message to all humanity in general and to the Muslims in particular. Muslims in America face numerous challenges in their attempt to implement Islamic financial strategy of equity financing. As U.S. citizens, they recognize that they live in a country where a individual liberties and economic freedoms are treated as articles of faith. They are actively supported, guarded, and pursued by the constitution and every organ of the state. The U.S is truly an economic powerhouse. Since 1994, it has added nearly $80 billion in real income, over $7 trillion in stock market wealth, and 9.5 million additional jobs. No other country in the world can claim such a dazzling economic performance. It is a country where a great majority of people are satisfied with their economic life. It is a country, which takes care of its poor through welfare, workfare, and active promotion of private charities through tax incentives. It is a country, which takes pride in taking care of its retired, and the disabled through Medicare, Medicaid, and Social Security. This dazzling economic record, by no means imply that the U.S provides a fault free economic panacea for the problems, of all its citizens. The major problem that many face in this country is the spiritual devoid and the duplicity, as well as irresponsible value neutral actions that it emanates. The immoral, unethical, and value neutral actions

of some individuals and groups are a result of an extremely liberal interpretation of the rights and the freedoms that the United States constitution allows. Due to the absence of faith in a Superior Being, some groups are focused primarily in promoting a purely materialistic approach to life's complex problems. It is in this area, that Muslims can make a positive contribution. As believers in a universal faith, Muslims are committed to promote absolute ethical and moral values. Therefore, they cannot stand by as neutral observers or critical evaluators. They need to recognize their role in active dawah and fully participate in the economic, social, and political affairs of their chosen country. Muslims as a group as well as in their individual capacity need to emphasize the benefits of incorporating an ethical and spiritual code of conduct in all worldly affairs. They need to establish and promote alliances with other morally and ethically driven groups in the United States, especially those who are involved in incorporating business ethics within the economic life of this nation. This will prove to be an effective strategy for the promotion and propagation of the message of Islam in America.

At the same time, Muslims need to recognize that in the economic arena, they face a number of challenges. As Muslim consumers, professionals, workers, and businessmen in America, they are confronted with an array of financial transactions, which involve interest. Since the entire U.S. financial system is interest based, it is impossible to pick and choose a purely interest free activity. As employees, as. well as employers, all Muslims in America receive income from various sources, which involve some interest-based transactions. The entire U.S. financial system is so engrossed with interest-based transactions that all the funds received in any form on any private or business account for any period of time, from any local commercial bank, savings and loan association, credit union, mutual money market funds, U.S treasury bills, savings bonds, or any other private or public bond of any duration are considered interest in Islamic Shariah. It is not in the area of receiving and earning incomes, but also in the payment of funds that interest becomes unavoidable. Transactions such as financing a car or house, engaging in credit card purchases, borrowing any money for education, or buying any household furniture and any other consumer item, all involve interest. U.S tax laws also encourage such interest-based transactions,especially the interest on the home mortgage.

The allowance for deducting home mortgage interest, coupled with high appreciation in home values during the last decade has provided an extremely attractive low cost financing and a long term saving option for a vast majority of U.S citizens.

It is very difficult for Muslims to ignore this seemingly attractive financial

option. It is especially a challenge for poor and lower middle income Muslims and the new immigrants who start their lives in the United States with only the resources of their labor and education. In searching for a way to finance their business with interest free financing, some of these individuals get so overwhelmed with the current economic system that they simply give up the economic commitment to their faith. This group of consumers needs to renew its commitment to Islam. The other group consists of those well-intentioned Muslim consumers who are sincere in their effort to follow the injunctions of their faith in their economic affairs. In doing so, these Muslims face numerous challenges. First of all, only a limited number of institutions provide interest free financing. Those few institutions that are engaged in Islamic financing are either very stringent in their requirements or they are non-competitive.

In addition, private higher education in the USA is expensive, with risky and uncertain returns. There are different degrees of risk involved when a loan is made to a medical student as opposed to a student who is pursuing a liberal arts degree. Refusing to finance educational loans or providing qarad-e-hasna funds, without regards to its use and future returns, is neither economically efficient, nor morally fair or justified.

In the area of investment, the stock market—provides a reasonable and to a degree Islamically permissible vehicle for savings. However the market, is highly unstable and uncertain in the short run. This uncertainty, has recently been magnified due to the overpriced stock market. If the stock market turns south, even the investment in utility stocks could face wide swings in prices. Exposing Muslim retirees to the vagaries of this market, and subjecting them to a substantial loss of their entire life savings is unwarranted and uncalled for. Islamic equity finance mode of investment needs to develop products which can provide returns on the basis of a person risk preference.

Another challenge emerges when the growing numbers of Muslims who are currently retiring on state or federally financed retirement funds or on social security are considered. All of them have contributed to these retirement funds without any control over its method of investment. These funds have primary been invested in U.S. government bonds at fixed rates. In the absence of an alternative, a number of theses Muslim retirees are confused about the proper course of action. Islamic mode of financing needs to find a solution for this problem from Shariah and communicate it in a convincing manner to the general Muslim population in this country.

Finally, Islamic banking institutions are being challenged by some Islamic economist with respect to a number of market performance measures and their lending policies. When the performance of some of these financial

institutions are critically examined and evaluated by Muslims investors. economists, and Shariah scholars within the framework of various measures, they are found to be undercapitalized, earning sub-par returns, lacking transparency and professionalism, unknown to the general public because of limited marketability and visibility, overly risk averse, and extensively engaged in Murabaha-cost plus short term financing.

Some of these problems can be attributed to the lack of sufficient funds and limited capitalization of these institutions. Until sufficient funds are raised internally by the Muslim community, its only hope is to rely on outside sources of funds. Major international Islamic financial institutions can assist the U.S. Muslim communities in this mutually beneficial effort. The United States Islamic finance market, can provide them a minimum risk, assets collaterize, equity based rate of return. It can also promise them a growing business opportunity with a rapidly expanding, over 8 million strong, highly educated, and financially sophisticated Muslim market.

The financial needs of this community are currently estimated at approximately 80 billion dollars with an expected annual growth of 15%. All that this growing community needs is products and services at a competitive cost. A number of Islamic banks have started to meet this challenge. Since the U.S. financial market is big and the customer base is large. Islamic financial institutions will have to get more extensively involved in a variety of financial areas, in order to make a meaningful impact in this expanding market.

The areas whuch currently, offer a great deal of potential for expansion include consumer finance, insurance, savings and investment, stock market investments, index options, investment products within various risk and reward categories, products and services for retirement planning, real estate investment, higher education financing, small business financing, home mortgage financing, as well as long tenm financing.

The investment of Islamic banks and a successful and profitable outcome for their business will be meaningfully enhanced if they conduct an extensive study of the U.S. banking laws with a view to explore legal avenues for the establishment of Islamic banking institutions at retail level.

Some of these issues are complex and defy easy solutions. However, financially sophisticated Muslim community, in the U.S.A. is not gong to accept simplistic and fatalistic answers to these economically complex problems. Most Muslims home buyers in the United States will find it naïve, unfair and unwarranted if asked to come up with a 25% to 50% down payment and still commit to make a 10% to 25% higher monthly payment, as compared to currently available market rates in the U.S. on the grounds that the former is halal and the latter is haram. These, and similar problems, need a con-

certed, intellectual effort within the spirit of ijtihad for their solution within the broad framework of Islamic Shariah and economics.

In order to provide answers to these and similar problems Muslim economists and financial practitioners will need to intensify their research and educational efforts in Islamic economics. They will need to place a specific focus on U.S. A. The needs of the hour are to establish more chairs in Islamic Economics, to start an American-Islamic economic and finance association, and to publish a refereed joumal on Islamic economics and fnance under ISNA's management and guidance. Organizations such as ISNA and Harvard Islamic economic forums have actually started to address some to these challenges. Islamic finance has already come a long way from 1963, when the first Islamic Bank was established in Egypt, with a meager capital of a few thousand dollars to the current total assets of over 6 billion dollars that the Islamic banks hold in their portfolios as of 1995. With the combination of this growth as well as the increasing individual and organizational involvement, these challenges will hopefully be met at a level, which is competitive with the conventional mode of financing as well as consistent with the rules of Shariah.

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Issues in Islamic versus Conventional Banking

By
M. Rafiq Bengali *

Islamic Banking as Compared to Conventional Banking:

Both Islamic and conventional banking deal with a common set of operating business realities, and therefore, there are many similarities between the two. In "Islamic Law and Finance" Vogel and Hayes say that in most cases, Islamic and conventional banking simply travel different paths towerds the same goal. At the same time, there are some important diffences and Islamic finance has been seen as an alternative to conventional banking. Yet, recent developments are leading us to believe that conventional commercial banks will be able to meet many of the needs of the Muslim community.

Islamic economists often refer to Islamic banking and finance as "*profit sharing.*" Where the conventional system is interest based. The essence of Islamic banking is an equitable partnership. The reward for savings and the abstention from consumption is not *interest* according to Islamic banking, but are *risk-taking, investment generating*, and income producing opportunities.[1] Given the ways in which finance is legitimately comprehended in the Islamic world, a useful way to describe the system of credit extension in the Islamic world is "*profit banking*". In Islamic banking, the rate of return on actual profit-sharing undertakings replaces the rate of interest. The emphasis of Islamic banking is on the human efforts, not on the amount of money employed without human effort. Islamic businesses can and do utilize financial leverage in their capital structures (E.g. through leasing). In this way they expose their owners to the potential enhancements of returns on equity if things go well and to value reduction if the results are less than projected.

Below are a few examples how an Islamic business would carry out the following activities:

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* Rafiq Bengali is General Manager and Regional Head of National Bank of Pakistan.

1) When a business needs long-term financing:
   In conventional finance: This is accomplished through a mix of long-term debt and owneship capital.
   The Islamic solution: A few options exist. One may be that passive partner's contract for a certain share of the profits, with another share going to the entrepreneurs who manage the business. Another alternative is leasing. A lease does not involve formal interest or a partnership stake.

2) When inventory financing is required:
   In conventional finance: Short-term inventory finance is obtained by purchasing it through credit from a commercial bank involving interest, or alternatively, through supplier financing.
   The Islamic solution: An Islamic business in need of short-term inventory financing can purchase the inventory on credit, that credit being supplied either by the inventory supplier or a bank. The bank can purchase the inventory for the business, as long as the business promises to buy the inventory later for a cost plus fair mark-up.

Innovations and the Recent Developments Which Will Further the Potential of Islamic Banking and Finance:

Those Islamic investors who follow their religious principles have had considerably fewer choices than conventional investors who can choose from a large amount of debt and equity instruments. These has recently been growth in the field of Islamic banking end finance in various financial centers around the globe. Currently in the United States, much attention is being given to existing Islamic contracts and ways to expand their uses in either their original or modified forms. Numerous major financial institutions worldwide are recognizing Islamic banking as a new opportunity for growth. An increasing number of firms are trying to establish Islamic practices in order to serve and satisfy this growing market. There has been a growth in Islamic mortgages, leasing and mutual funds that invest client monies in ways that do not conflict with the interests of Muslims.

The Office of the Controller of Currency, USA (OCC), has recently approved a proposal by the United Bank of Kuwait (UBK) to engage in real property lease financing of single-family residential real estate properties. This banking product was crested due to Islamic prohibition on interest lending. The financing framework that is based on lease-purchase financing can be summarized as a process by which the lessee finds the property, nego-

tiates the terms of sale and makes a down payment. The bank determines whether the lessee is creditworthy. If so, the bank will purchase the property along with the legal title. The property is then leased to the lessee. The lessee is required to take all responsibility for the property and make monthly lease payments and payments sufficient to amortize purchase price of the lease. When the lease is terminated, the lessee becomes the owner of the property.

Another good example is the alternative mosque financing that has been developed for Muslims living in the West. This alterative financing framework is both Islamically acceptable, pragmatically achievable, and can be carried out by a commercial bank. In this alternative mosque-financing plan, a community that wants to expedite the process of mosque building is required to enter into an agreement with a bank. The bank provides funding for the construction of the building and then purchases the title to the project through a special-purpose vehicle. The community leases the building, has to pay for the cost of leasing, and also makes regular equity payments in order to acquire equity ownership. In order to attain this, a required number of credit-worthy members of the community must be willing to open or transfer the minimum account balance required for participation with the bank. These community members must also maintain a minimum account balance required for participation with the bank. These community members must also maintain a minimum balance with the bank for the life of the deal. They must also allow the bank to deduct a fixed amount from the accounts monthly. The amount that is deducted from the community members' accounts is used to pay partially for the fixed cost for leasing the building and partially to purchase equity from the SPV. If a member relocates, participation can be transferred to a standby community member. The community will continue to have fundraisers and will fund the debits from the accounts, by giving the participants part of the amount that is deducted from their accounts by the bank. When the entire equity is purchased from the SPV, the title of the project will belong to the community. In order to allow tax deductibility of monthly payments, the SPV wil be a non-profit entity. It is believed that there should be no *sharia* objections, given the *ijara wa Iqtina* or lease purchase financing structure.

Issues and Opportunities:

• American commercial banks had been prohibited by US federal and local state banking authorities, from offering Islamic banking products and services that are risk taking partnership ventures. U.S. regulators have been concerned about commercial banks using depositor money for engaging in

risk-taking ventures. Recent development, though, prove that obstacles can be overcome, and that through educating and making law-makers understand and accept Islamic banking, commercial banks can get regulatory approval for Islamic banking products. (e.g. OCC approval of UBK proposal.)

• The *Sharia* boards of Islamic financial institutions should provide consistent rules and rulings. The availability of universal regulations will enhance growth and development in the area. The creation of institutions like the Fiqh Academy, associations of Islamic banks, international standards organizations etc., will increase the capacity for ordered, systematic legal development. These institutions will be able to introduce uniformity of legal opinion which is needed for further development of Islamic banking.

• Other obvious impediments that slow the growth of Islamic banking and finance are the lack of liquidity, a limited set of approved instruments, cumbersome transactional arrangements, and the lack of ready provisions for risk management. Better capitalization, encouraging financial engineers to simplify structures, and professional marketing will further aid the development of Islamic banking.

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A Comparative Study of Various Islamic Models of Home Financing

By
Pervez Nasim *

Traditionally, owning a house was not just a necessity of life; rather, it has also been and still is a source of family pride and financial security. The steady increase in home prices and an increase in demand for cash for other family needs made it impossible for individuals and young families to come up with a substantial amount in cash to buy a house.

The thoughts of saving money now and buy later, scared many people when they realized that their savings will never be able to catch up with the increase in the real estate prices. Since there were no adequate Interest Free House Financing alternatives available, this forced many Muslims to follow non-Muslims in obtaining riba-based financing from conventional financial institutions in non Muslim countries as well as, unfortunately, in many Muslim countries.

As a result of colonization of Muslim countries, there were hardly any alternate sources of financing available to Muslims. Most of the alternatives were limited to the books written by some Muslim scholars with some knowledge of Shariah and modern economics. There was no practical model available any where in the Muslim countries that could meet all the challenges of modern business, trade, commercial and economic practices, which could also operate within the prevailing taxation and legal framework.

Interest Free Islamic Alternatives

Let us now examine what are some of the Interest Free alternatives available to us for financing house purchases.

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* Perez Nasim is President of Islamic co-operative Housing Corporation in Toronto Canada.

MODEL A: Lease with option to purchase

A Prospective home buyer selects the housing unit after meeting certain qualifying requirements laid down by the institution. These requirements may include:

—Minimum investment in the institution.
—How long the investment has been with the institution
—Family income
—Need of the family etc.

In this model the institution purchases the desired housing unit in its name and leases it to the prospective home buyer at a mutually agreed rent for a fixed or flexible term of period with an option to buy the housing unit later at a price to be negotiated, or determined based on then fair market value.

During the lease period the prospective home buyer is required to invest additional savings in the institution. He is also required to pay full rent every month but he is entitled to profit/dividend on all of his investment in the institution.

At the end of the term of the lease or any other time, if it has a flexible term, the individual can exercise his option to purchase the house by surrendering his investments in the institution and paying some cash as needed, against the purchase price, and have the legal title to the housing unit transferred to his name. This completes the transaction in an Islamic way without involving interest.

Strengths and Weaknesses of the Model:

Like any model it has some strengths and some weaknesses. This Model is very simple, straight forward and easy to administer.

Since it is a rental property with option to purchase, the responsibility of maintenance and upkeep rests with the institution.

The prospective home buyer will have a free hand but the institution may have to employ maintenance staff.

This Model has an open-ended price option, therefore, it may be less attractive to the prospective home buyer. Any increase in the value of the property solely goes to the institution and this defeats the purpose of safeguarding ones savings against inflation and providing protection from the situations where house prices go beyond one's reach.

MODEL B: Purchase on installments

In this Model a prospective home buyer, after meeting the qualifying

requirements of the institution, chooses the house and negotiates the price with the vendor/builder in consultation with the institution. The institution purchases the housing unit by paying full cash to the vendor and takes over the title/ownership of the property. Then the institution sells the housing unit to the prospective home buyer at cost plus a mark up or profit with the condition that the home buyer will pay a certain portion of the purchase price now and the balance in equal monthly installments over a certain previously agreed period. At this point the title to the property is transferred to the individual and a charge or lien is registered on the title in favor of the institution as a security against the unpaid monthly installments.

During the term of this agreement the home buyer has all the rights as an owner except the right to sell. He is responsible for repairs and maintenance etc. and he also carries all risks. At the conclusion of the agreement when all the installments are paid, the institution removes the charge or lien from the title of the housing unit and at this stage the individual becomes the clear owner of the housing unit.

Strengths and Weaknesses of the Model:

The strengths of this Model are that again it is very straightforward and easy to administer.

The prospective home buyer knows in advance how much the unit will cost him. Determination of monthly installments is usually flexible and these may be tailor made to suit one's income by spreading over more or fewer number of months.

The biggest weakness in this Model is the problem of predicting the future value of the house over a long period of 7 to 10 years.

How much should the mark up or profit on this purchase and sale should be? This Model requires a long term commitment that individuals find difficult to make. They face lots of uncertainties in the future and they have apprehensions about their ability to carry this commitment thorugh over such a long period. They cannot easily get out of this commitment during the term of the agreement, specially, when the property value has not reached the expected level. They are likely to suffer a huge financial loss of their savings/investment if they wish to terminate the agreement before its maturity.

Moreover, since in this Model there is no sharing of profit or loss between the individual and the institution, it may turn out to be a very unjust and unfair transaction in the end, for one party or the other.

MODEL C: Decreasing Partnership (Rent to Own Concept)

In this Model an individual is required to first invest his savings in the institution for a certain length of time.

Afterwards when he fulfils all the requirements of the institution, he is authorized to locate and negotiate the purchase of the house. The institution pays cash for the housing unit and obtains the legal title in its name.

At this time the prospective home buyer transfers his investment in the institution to this housing unit and becomes a co-owner. This process forms a Partnership relationship with the institution. This Partnership leases the housing unit to the prospective home buyer at an agreed monthly rent. According to the terms of agreement between the individual and the institution (between partners) the individual is committed to purchase this house at a later date, and thus, is required to increase his ownership (Equity) in the housing unit over a period of time by purchasing more shares in the housing unit from the institution.

During the term of this rent to own Partnership, the individual pays institution's share of the monthly rent and keeps his own. With this proportionate rent saving and other savings the individual can increase his ownership of the house every month if he wants. Whenever the individual increases his ownership in the house by purchasing more shares of the housing unit from the institution, his rental payment for the following month decreases in the same proportion. The individual is responsible for paying repairs and maintenance. Some expenses of capital nature are shared in a previously agreed ratio by the individual and the institution. The housing unit is evaluated when the individual completes the purchase of all required shares (Equivalent to the cost). Any increase or decrease in the value is shared between the partners (the prospective home buyer and the institution) in some previously agreed ratio. If there is a net increase (Gain) in the value of the housing unit, the individual pays to the institution its share of that gain, and- if there is a net decrease (Loss) in the value, the institution pays its share of the loss to the individual, and transfers the legal title to the prospective home buyer. At this point the Partnership terminates and the individual becomes a full owner of the housing unit.

Strengths and Weaknesses of the Model:

Unlike the two previous Models this model is more equitable and fair since both parties share the fluctuation in the value of the property in some predetermined ratio. There is no need to predict or guess the future value of the property. There is no prefixed time limit in this Model, therefore, it provides maximum flexibility to the prospective home buyer. At the same time

they enjoy immediate savings in the rental payment I proportion to their increase investment in the house.

In terms of weaknesses, this Model is a little hard to administer. It requires constant recalculations of monthly rental payments and documentation of changes in the ownership ratio. Moreover, the individual is committed to ultimately own the housing unit and he cannot easily get out of this commitment. He will have to find another buyer if, for some reason, he does not want to complete the purchase of the house. In spite of these weaknesses, this Model is more feasible, fair and practical. Housing Coop in Toronto is operating successfully for the past 17 years, under this model.

ISLAMIC COOPERATIVES-PATHWAYS IN ISLAMIC FINANCE

By
Imtiaz Ali *

Abstract

This paper attempts to examine the role and functions of co-operatives as viable socio-economic institutions capable of operating within the framework of Islamic Shariah and promoting and practicing the principles of Islamic Finance especially among Muslim minorities in democratic societies. The thesis is based mainly on the experience of the Muslim Credit Union Co-operative Society Limited (MCU) in the Republic of Trinidad and Tobago (T&T).

Introduction

Over the past twenty years, Islamic Finance has manifested itself mainly in the co-operative sector in T&T. In 1983 the Muslim Credit Union (MCU), the first Islamic Co-operative in T&T was formed. Subsequently, two other co-operatives were formed, the Islamic Housing Co-operative (IHC) in 1992 and the Anjuman Sunnat ul Jamaat Association (ASJA) Co-operative in 1994. An unsuccessful attempt was made in 1994 to establish an Islamic Agricultural Co-operative. Efforts are currently underway to set up other Muslim co-operatives in T&T.

Why Co-Operatives

There are several reasons why Islamic Finance grew from within the Co-operative sector in T&T. The Islamic Finance movement was initiated by people who were more or less "non-professionals" and who lacked

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detailed knowledge of conventional and Islamic Economics, Banking and Finance. Since the initial approach to Islamic Finance was aimed at providing 'interest-free credit' the Co-op Societies Act accommodated the operation of an interest-free Credit Union. The start-up capital for a Credit Union was negligible and was achievable within a short period of time. Co-operatives allow for the mobilization of funds through deposits and shares and direct and indirect investments of such funds, the kind of leeway needed by Islamic Financial Institutions. The absence of any taxation on profits also made the co-operative option more attractive. The philosophy and principles of co-operatives were found to be in conformity with the philosophy and principles of Islam. The co-operative sector appeared to be more informal and people oriented than the banking sector. It allows for the nurturing of brotherhood, co-operation, self-help and philanthropy and places great emphasis on the education of its members.

Co-operation

The term co-operation, in a loose sense, conveys the idea of working together toward achieving some goal. From the very beginning of human society, co-operation (whether voluntary or enforced) has always been an intrinsic factor in human development. Because the individual, by himself, cannot produce all the various necessities for continued existence and reproduction, co-operation has always been necessary, and human society as it developed along the lines of increasing differentiation and specialization among its members, has increasingly needed co-operation among them as the 'sine qua non' for its continued existence and development.

"Co-operate in righteousness and piety but do not co-operate in sin and rancour: fear Allah for Allah is strict in punishment." Holy Quran, ch. 5, v. 2.

Co-operativism

It is not until the middle of the 19th Century, however, that we can attest to the emergence of' "Co-operativism" (as distinct from co-operation in the loose sense) and the Co-operative Movement, as we use the term today. On the 24th of October, 1844 in Rochdale, Lancashire, England, a group of people faced with economic exploitation and deprivation set up a consumer co-operative store, based on the principles of self-help and mutual help. These Rochdale Pioneers were able to define a set of principles which became the basis for the ideology of Co-operativism—an ideology which has now spread over the entire world. Thus we may define Co-operativism as an ideology which sees self-help and mutual help as a way of life and a method of development for human society. It is important to note that for the

Rochdale Pioneers, Cooperativism was not a matter of mere pious wishes and sentiments, but a practical method of organizing and running a store.

Although group efforts towards community development started long before the advent of Prophet Muhammad (upon whom be peace) in the sixth century (CE), it became enshrined in the belief system of bution and circulation of wealth; lists poverty eradication as an aim; re-affirms the unity and equality of mankind; establishes the concept of community; orders continuous education for all; extols consultation in decision making; defines lending money as an act of charity and bans usury/interest.

While business partnerships (musharaka, mudharaba) were widely practiced by the pre-Islamic Arabs, they got a boost from Islam which not only sanctioned them but provided some additional rules to govern such transactions. Prophet Muhammad (uwbp) is reported to have said. "The Hand of Allah is on those partners who are not dishonest." (*Abu Dawood*).

Co-operative Societies

The term "co-operative" itself we may define, following the International Labour Organization at its 50th Session in 1966 which adopted Article 12 of the Co-operatives (Developing Countries) Recommendation, as 'an association of persons who have voluntarily joined together to achieve a common end through the formation of a democratically controlled organization, making equitable contributions to the capital required and accepting a fair share of the risks and benefits of the undertaking in which the members actively participate'.

Together with this definition comes a set of principles which define the co-operative form of organization—they tell us of the essential properties of a co-operative organization. *See Appendix 1 for Revised Definitions & Principles*

The International Labor Conference Recommendation 127 concerning co-operatives states that the establishment and growth of co-operatives should be regarded as one of the important instruments for economic, social and cultural development as well as human advancement in developing countries. It further states that co-operatives should be established and developed as a means of—

(a) improving the economic, social and cultural situation of persons of limited resources and opportunities as well as encouraging their spirit of initiative;
(b) increasing personal and national capital resources by the encouragement of thrift, by eliminating usury and by the sound use of credit;
(c) contributing to the economy an increased measure of democratic

control of economic activity and of equitable distribution of surplus;

(d) increasing national income, export revenues and employment by a fuller utilization of resources, for instance, in the implementation of systems of agrarian reform and of land settlement aimed at bringing fresh areas into productive use and in the development of modern industries, preferably scattered, processing raw materials;

(e) improving social conditions, and supplementing social services in such fields as housing and, where appropriate, health, education and communications;

(f) helping to raise the level of general and technical knowledge of their members.

Co-operatives in Trinidad and Tobago

It appears that the origins of co-operative societies in T&T go as far back as the 1920s (Develtere 1987). Churches are credited with planting the seeds of credit unionism in several Caribbean countries including Dominica, Barbados, Antigua, Jamaica and Trinidad and Tobago (Develtere 1987). Islamic co-operatives, however, were introduced in 1983 in T&T and 1988 in Guyana.

Today the co-operative sector, the third sector, in T&T is made up mainly of credit union, agricultural, transport, producer, consumer, fishing, workers' and junior co-operatives. Unofficial government statistics currently estimate the number of active co-operatives to be 600 with a total asset base of approximately 4 BTTD and involving between 35 and 40 per cent of the total population.

It should be noted that the laws of T&T governing co-operative societies are now being amended to allow corporations to become members of co-operatives This until certainly open new windows of opportunity to the co-operative sector.

Co-operatives Around the Globe

The largest number of co-operatives are found in the highly industrialized nations which include Japan, Canada, U.S.A., England, Germany and many of the countries of Western Europe. Co-operatives also exist in the developing nations of Africa, Asia, Latin America and the Caribbean although they are not as widespread.

In Canada, approximately one-third of the population belongs to co-operatives which provide farm supplies, loans, housing and health care among other goods and services. Wheat farmers from the Prairie Provinces (Alberta, Saskatchewan and Manitoba) often market their crops through

"wheat pools' which are basically large co-operatives and one of which—the Saskatchewan Wheat Pool—is the world's largest marketing co-operative.

Among other countries the largest number of co-operatives is found in

INTERNATIONAL CO-OPERATIVE ALLIANCE
Membership Statistics as at 01 July, 1998

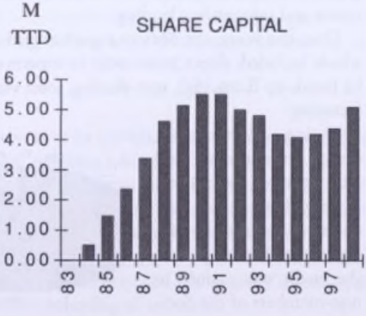
	Countries	Societies	Members
Americas	18	43,945	182,486,437
Africa	12	27,214	9,561,443
Europe	35	197,293	118,473,862
Asia	28	480,648	414,383,079
Total	93	749,100	724,904,821

Source: There are countries with co-operative societies who are not members of the IXA eg. Trinidad and Tobago

the Scandinavian nations i.e. Norway, Denmark and Sweden where 15% of retail business is done by co-operatives. The farmers of 3 countries belong to marketing co-operatives and often, housing co-operatives. The populations of Finland, France, Great Britain, Iceland, Italy and Switzerland are also substantially members of co-operatives.

Capital

Probably, the main reason why Muslims chose to establish a co-operative rather than any other financial institution was the start-up capital needed. In the eighties the paid-up share capital needed to establish a commercial bank was three million dollars (3M TTD) and three hundred thousand



dollars (300,000 TTD) for a non- banking institution such as a Merchant Bank, Unit Trust. Finance House. Trust etc.

The start-up capital needed for co-operatives is normally related to the nature or business of the co-operative. By pooling their resources, practicing thrift and sound use of funds, members of co-operatives are able to raise the capital needed for starting business ventures.

The MCU originated from a group of young Muslims who were pooling their savings in order to provide. interest-free loans to members of the group. By the time the idea of the co-operative took shape in mid 1983, the potential members had already saved in excess of $50,000—(approx. 10,000 USD at the time) As at the end of June 1998, the share capital was $5.1 M TTD (.8M USD)

Islam recognizes savings as a genuine positive economic activity of man and classifies spendthrifts as brothers of Satan. The building of capital through savings, therefore, is quite acceptable in Islam.

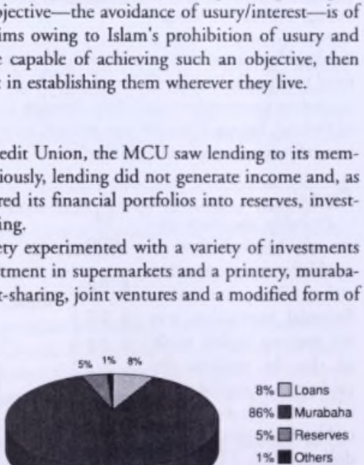
It should be borne in mind, that one of the stated reasons for the formation of co-operatives is the avoidance of usury through the pooling of resources and thrift. This objective—the avoidance of usury/interest—is of greater importance to Muslims owing to Islam's prohibition of usury and interest. If co-operatives are capable of achieving such an objective, then Muslims should be foremost in establishing them wherever they live.

Financing & Investments

Having registered as a Credit Union, the MCU saw lending to its members as a major service. Obviously, lending did not generate income and, as a result, the Society structured its financial portfolios into reserves, investments and interest-free lending.

Over the years, the Society experimented with a variety of investments which included: direct investment in supermarkets and a printery, murabaha (mark-up financing), rent-sharing, joint ventures and a modified form of factoring.

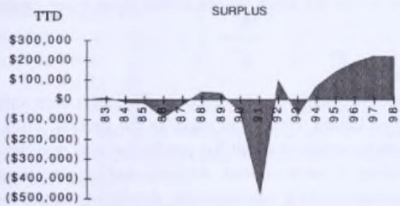
Owing to losses in the direct investments and joint ventures, low returns in rent-sharing and government's request to withdraw from factoring since the credit was mainly to non-members of the Soci-



ety, the MCU's main instrument at present is Murabaha.

Every co-operative is a partnership. Members buy shares in the co-operative which is managed by people (directors) elected from within the membership. The directors manage the funds of the society by investing in various types of activities depending on the objectives of the co-operative. Co-operative projects include investment in farms, supermarkets, housing, equipment, construction, credit, telecommunications, manufacturing, processing and marketing. Cooperatives can trade, lend money, rent and lease property, equipment and machinery, charge commissions and fees for services and share in the profits of joint ventures with other entities.

Surplus (Dividend)



Although the main thrust of co-operatives is 'not for profit but service to its members this does not preclude the payment of dividends and patronage refunds to shareholders when there is a surplus. This is quite acceptable in Islam which prohibits interest payments but allows dividends and patronage refunds. Co-operatives are quite capable of paying dividends which can match the prevalent interest rates on fixed deposits.

It is interesting to note that despite the non-payment of a dividend for the past seventeen years, the MCU's membership has continued to grow while its share capital, though having shown some fluctuation, is also on the increase.

Auditing

While co-operatives may appear to be informal types of institutions, there is a great emphasis on auditing. Auditing takes place at different levels.

The Society audits itself, by way of a Supervisory Committee. The MCU since its establishment in 1983 has consistently elected a Supervisory Committee from among its membership at its Annual General Meetings.

An external auditor is selected from an approved panel of auditors issued by the Co-operative Division o the Ministry of Labour and Co-operatives and is approved by the general membership at an AGM.

The Co-operative Division of the Ministry of Labor and Co-operatives also does its own auditing and supervision of co-operatives.

Annual financial statements include a Balance Sheet, an Income and Expenditure Account, a Receipts and Payments Account and Notes to the Financial Statements.

Taxation

Ever since their inception, co-operative societies in T&T have been exempt from paying tax on profits.

During 1985 to 1996 members of co-operatives were granted tax relief for increased share holdings (maximum 2,500 TTD) in co-operatives. This policy resulted in the growth of both the membership and share capital of co-operatives and especially credit unions throughout the country.

The removal, however, of the tax relief in MCU nor from other credit unions.

Community Development

By pooling its resources, the Muslim community in T&T, has been able to provide certain aspects of Islamic Finance to itself. In the process, members have been saving money; accessing credit for productive and non-productive purpose; participating in consultations, decision making, meetings and educational programmes; creating employment; developing entrepreneurship and contributing to poverty alleviation.

The Muslim co-operatives have added new dimensions of integration and cohesion to the traditional concept of Jamaat in T&T. While Jamaats continue to play a very significient role in running the affairs of the Mosque, most of them are not structured to accommodate participation of the worshippers in decision making and lack proper accountability, reporting and transparency. Many young Muslims whose skills and energy are not tapped by Jamaats voluntarily provide several man-hours per month to the operation.

Membership

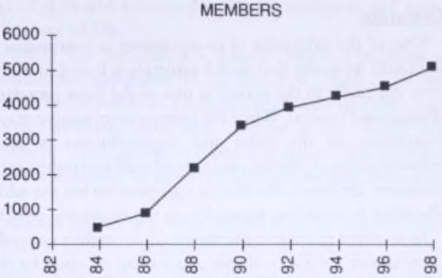
Co-operatives are associations of people. They are built on a common bond of association among its members. Some common bonds are the work place, religion, trade unions, the community, profession, club or social group.

Membership in the MCU is open to "all persons of good character who are members of the Islamic faith and belong to Ahlus Sunnah wal Jamaah in the Republic of Trinidad and Tobago."

The ASJA Co-operative's bond of association is "Members of ASJA" and

the bond of association for the IHC is "All persons of good character aged sixteen (16) years and over who are members of the Islamic Faith and belong to the Ahlus Sunnah wal Jamaah who are interested or engaged in ownina a home within the area of operations of the Society."

The underlying philosophy of co-operatives is that they are institutions established by people for their own benefit, owned by them and managed by them. People are at the centre of co-operatives.



The MCU was established by Muslims with the aim of providing Islamic Finance for their own benefit and to be managed by themselves. It provided and continues to provide a tangible opportunity for Muslims to work with each other for their mutual benefit.

Co-operatives continue to demonstrate that average people can successfully operate their own Financial Institutions and businesses.

Organization

Co-operative Societies are democratic organizations. Their affairs are administered by persons elected or appointed in a manner agreed to by the members and accountable to them. All members enjoy equal rights of voting—one member, one vote. The destiny—success or failure—of any co-operative rests, to a large extent, in the hands of those members who are elected to serve on the Board of Directors. Directors and Statutory Committees such as the Supervisory Committee and in the case of Credit Unions, Credit Committees are elected on an annual basis. Other Committees including the Statutory Education Committee are appointed on an annual basis. Co-operatives employ fulltime staff depending on the various factors which determine the need for such.

Self-Help and Voluntarism

While the MCU's current staff stands at five individuals, there are in excess of fifty members who are contributing to the operations and develop-

ment of the Society on a voluntary basis.

Self-help and voluntary work are the backbone of the co-operative movement. These principles are not alien to Islam and, as such, Muslims have welcomed co-operative societies as a practical means to demonstrate their faith.

Education

One of the principles of co-operatives is continuous education There is absolutely no doubt that such a principle is found in Islam. "Seek knowledge from the cradle to the grave," is one of the most popular sayings of Prophet Muhammad (uwbp). While the average co-operative may focus its education programme on the rights and responsibilities of members, duties and responsibilities of officials, training of staff and public awareness on what co-operatives are about, the Islamic co-operative has the added responsibility of educating its members especially on the economic aspects of Islam.

In an effort to achieve the above, co-operatives normally set up Education Committees. Educational ventures embarked upon by the Education Committee of the MCU and other ad-hoc Committees were: Member Education, Staff Training, Seminars, Lectures to develop awareness among Muslims, exhibitions, publishing of flyers, brochures, newsletters, newspaper supplements and booklets, panel discussions, publishing of Khutbahs (Sermons), hosting of international conferences on aspects of Islamic Economics, participating in conferences and training courses in Islamic Economics, Banking and Finance, radio and television interviews, the setting up of a small library in its Head Office, and hosting renowned persons from outside of T&T in the field of Islamic Economics, Banking and Finance

Human Advancement

MCU Zakaah Disbursements for 96/97

Category	Appl's	AMT Dis
Groceries	17	$5,449
Home Const./Rep.	7	$5,400
Business/Equip. Rep.	3	$3,300
School Fees/Books	7	$2,700
Medications	8	$2,400
Debt Repayment/Bills	5	$2,708
Total	47	$21,957 TTD

The essence of the co-operative is the doing of good. It is seen as an instrument of human advancement through economics, social and cultural development. It provides an opportunity for people of limited resources to improve themselves by bonding with others and provide a boost to their spirit of initiative.

The first general objective of the MCU as listed in its By laws is "The promotion of the economic welfare of its members."

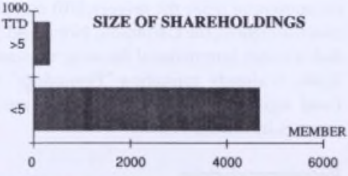
Through the efforts of the MCU, Muslims have been able to develop the practice of thrift, create new jobs, provide funding for productive purposes, develop a wide range of skills and increase people's knowledge of and commitment to the Islamic way of life.

Since 1985, the MCU has established a Zakaah Fund. This fund is administered by a committee appointed by the Board of Directors of the Society. The Committee is comprised of a minimum of three members and a maximum of five, one of whom must be a Director of the Society and another an Islamic Scholar. The Committee, which meets at least once per month, is vested with the authority of assessing applications and disbursing Zakaah.

A specific form "*Zaknah Application Form*" which must be completed by all applicants, captures the necessary information on the applicant. However, site visits are conducted by members of the Zakaah Committee in order to verify information received and to further assess needs.

The MCU continues to provide this service in a cost-effective manner since the cost of administering th Fund is borne by the Society and the members of the Zakaah Committee provide their services voluntarily, Up to now, one hundred percent (100%) of every dollar received is disbursed to the poor, unlike other types of poverty reduction programmes.

Brotherhood



Co-operatives provide opportunities for people to build relationships. Co-operation signifies team work—people working together to achieve common goals. This coming together and working together allows people to understand one another and in this way, brotherhood and unity are nurtured. These are Islamic goals.

The MCU has been able to attract Muslims of various ethnicities, professions, educational background, Jamaats and Islamic organizations. Although the membership of the MCU is predominantly of Indian ethnicity as a result of the racial composition of the wider Muslim population, Muslims of African origin have served as President, Vice-President, Secretary, and member of the Board of Directors and on other statutory and ad-hoc Committees.

The co-operative principle of "one member one vote" which bestows equal status to all members irrespective of their share holdings also contributes to the building of brotherhood and the feeling of equality. It preserves the dignity of man by treating all individuals as human beings.

The Future

The future of Islamic Finance in T&T can be looked at from two angles: (i) Efforts by Muslims and (ii) Efforts by non-Muslims.

One can expect efforts by the MCU to increase its share capital and membership in an effort to pay reasonable dividends to its shareholders. The MCU may also increase its number of financial products/instruments and work towards improving its customer relations, image ends services.

Other co-operatives may also be established as "co-operativism" becomes more entrenched within the Muslim Community. Co-operatives may very well be the best mechanism for partnerships and joint venture projects for many of the reasons afore-mentioned.

In an effort to cater to the needs of corporate and non-Muslim clients and broaden the scope of Islamic Finance, IFIs may be established under the Companies Ordinance and eventually under the Financial Services Act. The MCU has already established a special committee to examine this approach.

Initiatives have already been made by non-Muslims to provide Islamic Financial products. A local group CL Financial Group, via its Investment Bank, has already shown an interest in setting up Islamic Financial Products. CL Financial Ltd. is one of the largest conglomorates in the Caribbean encompassing more the seventy (70) companies operating in diverse industries throughout the Caribbean, North and South Americ and Europe. Mondial, another international financial services group with an office in Port-of-Spain, is already marketing "Flemmings" Oasis Fund, an Islamic Mutual Fund registered in Luxemburg. There are others who have also expressed interests in Islamic Finance.

Recommendations

(1) Whereas there already exist Islamic co-operatives in different parts of the world and whereas there is an increasing interest in setting up new Islamic co-operatives in various countries, I propose the establishment of an International Federation of Islamic Co-operatives (IFIC) to promote and develop Islamic Co-operativism among Muslims worldwide.

(2) In the spirit of co-operation among co-operatives and self-help, existing Islamic co-operatives should take the initiative to establish the IFIC.

(3) Institutions such as the Organization of Islamic Conference (OIC),

Islamic Development Bank (IDB) Islamic Research and Training Institute (IRTI) and other Islamic bodies could examine their possible roles in the establishment and operations of the IFIC.

Conclusion

In conclusion, I wish to emphasize that although very developed and sophisticated banking and financial sectors exist in the developed countries, the co-operative sectors in those countries continue to develop and thrive. I strongly recommend that the proponents of Islamic Finance take a serious look at co-operatives as viable socio-economic institutions which have the potential of bringing people closer to Islam than the conventional approach to Islamic Finance with its emphasis on the formation of banks, Murabaha transactions and rate of return on investments. Understanding the nature of Islam, one may suggest that Islamic Finance may be more welcomed and stands a better chance of flourishing in the co-operative sector than the banking sector in non-Islamic states and among Muslim minorities.

Appendix
Revised Principles of Cooperatives

What is a co-operative?

Definition

A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.

Values

Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.

Principles

The co-operative principles are guidelines by which co-operatives put their values into practice.

1st Principle: Voluntary and Open Membership

Co-operatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination

2nd Principle: Democratic Member Control

Co-operatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives members have equal voting rights (one member, one vote), and co-operatives at other levels are also organized in a democratic manner.

3rd Principle: Member Economic Participation

Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the cooperative; and supporting other activities approved by the membership.

4th Principle: Autonomy and Independence

Co-operatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.

5th Principle: Education, Training and Information

Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They inform the general public - particularly young people and opinion leaders—about the nature and benefits of co-operation.

6th Principle: Co-operation Among Co-operatives

Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional, and international structures.

7th Principle: Concern for Community

Co- operatives work for the sustainable development their communities through policies approved by their members.

This Statement on the Co-operative Identity was adopted at the 1995 Congress and General Assembly of the International Co-operative Alliance, held in Manchester to celebrate the Alliance 's Centenary. Recommended to the Congress by the ICA Board, the Statement was the product of a lengthy process of consultation involving thousands of co-operators around the world. The process was chaired by Ian MacPherson of Canada, who prepared numerous drafts of the Identity Statement and its Background Paper in an effort to understand the state and needs of the co-operative movement at the end of the twentieth century.

FUTURE OF ISLAMIC BANKING IN CANADA

By
*Said Zafar**

Canada is one of the five richest countries in the world in terms of GNP and at the top of the list of countries when measured in terms of quality of life.

According to current statistics, Canadats population is 29 million. Muslims make up half a million of this total.

Canada's economy is a mixture of agriculture and industries.

In the financial service area, Canada's 54 banks employ more than a quarter of a million people, manage over $1.2 trillion in assets and operate over 8140 branches and 14,484 banking machines (ABMs).

The first attempt to open a Canadian bank was made in 1792.

Several attempts were unsuccessful, but in 1817 nine local merchants formed the Montreal Bank. Over the next 50 years, 34 more banks were established.

Since the 1950's banks have undergone a dramatic transformation. Growing business volumes, changing customer needs and the rapid expansion of international trade forced banks to introduce more automation and offer a greater range of products and services.

In early 1992, the BANK ACT and the legislation governing other types of financial institutions underwent revision. It allowed for increased competition by permitting banks, trust and loan companies and insurance companies to diversify into each other's markets.

In December 1996, the federal government established the TASK FORCE on the Future of the Canadian Financial Services Sector. The members of the task force traveled across the country to solicit recommendations on a wide range of issues September 1998.

* Said Zafar is currently chairman committee on Islamic Financial Institutions Canada.

The Committee on Islamic Financial Institutions in Canada was asked to present views on the basis of the committee and their presentations.

The task force did not find any difference between the Canadian banking practices and the Islamic model of financing. The chairman of the task force even asked the Islamic financial group to apply for an Islamic bank in Canada. The establishment and growth of Islamic banks housing depends primarily on the size and the interest of Muslim population. We were questioned for over two and half hours and at the end, the Chairman, Harold MacKay, concluded with a remark: " We do not find any significant difference between your system and ours. Why don't you apply to operate an Islamic bank in Canada?"

The earliest account of a Muslim presence in Canada dates back to 1871-four years after Confederation-when there were 14 Muslims reported. By 1901, numbers had increased to about 300. Tables 1 and 2 and the following charts summarize the data on Muslim population and Islamic organizations.

Table 1

PROFILE OF THE IMMIGRANT POPULATION, 1991
Muslims Only

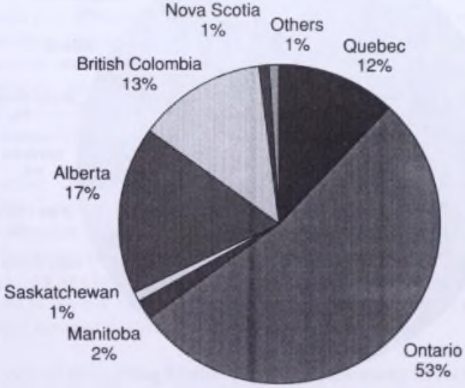
Province	Male	Female	Total
New Foundland	205	95	305
Pr. Edward Islands	25	35	60
Nova Scotia	830	605	1435
New Brunswick	155	90	250
Quebec	26,910	18,015	44,930
Ontario	78,020	67,540	145,560
Manitoba	1,900	1,625	3,525
Saskatchewan	625	560	1,185
Alberta	16,180	14,825	31,000
British Columbia	12,975	11,955	24,930
Yukon	25	10	30
North West Tarriteries	40	15	50
Total	137,895	115,365	253,260

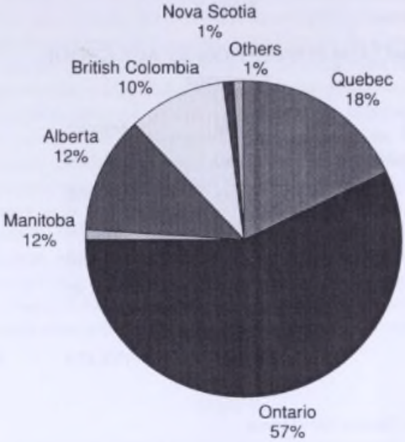
Table 2

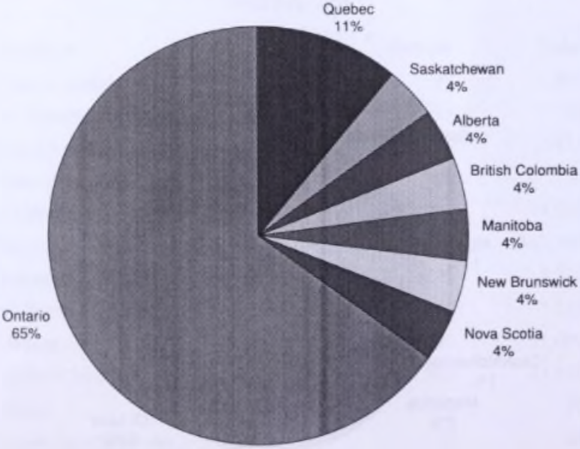
MUSLIM POPULATION BY AGE GROUP
in canada

AGE	Male	Female	Total
Less than 15 Years	35,950	34,625	71,575
15-24 Years	20,995	19,005	40,000
25-44 Years	56,175	42,510	98,690
45-64 Years	20,205	15,060	35,265
65 & Over	3,570	4,170	7,735
Total	137,895	115,370	253,265

Source: Statistics Canada 1991 Cansus




Nova Scotia
1%
Others
1%
British Colombia
10%
Quebec
18%
Alberta
12%
Manitoba
12%
Ontario
57%


Quebec
11%
Saskatchewan
4%
Alberta
4%
British Colombia
4%
Manitoba
4%
New Brunswick
4%
Nova Scotia
4%
Ontario
65%

Today, there are at least 500,000 Muslims according to Statistics Canada. Muslims are a quarter of Canada's non-Christian population and are the largest religious group after Christians.

Today's Muslims are a much younger group than the rest of the Canadian population almost a third (30%) is under the age of 20.

Muslims are spread out in various provinces. Ontario, where over 60% of the Muslim population are located, is the hub of Islamic activities.

Muslims are second only to Jews as the most educated of the minorities. 17% of them have finished 18 years or more of education.

This growing young and educated Muslim population is significantly contributing to Ontario and Canada's economic growth. Significant sums of savings are lying idle and untapped, waiting to be channeled into Islamic financial products. This unutilized reservoir of savings in Muslims hands could be put into use and utilized as source of working capital and venture capital for small and medium sized Canadian corporations.

The free enterprise mode of Canadian economy can further provide competitive avenues for the development of these savings. It can provide the largest amount of financial resources for the development of Islamic banking institutions in Canada. Isabel Bassett, a provincial Minister and the luncheon speaker at the Second Islamic Banking Conference held June 3rd 1997 brought this point when he said:

> "The debate on Islamic banking is no longer restricted to the Islamic world or just Muslim nations but is broadening to include non Muslim countries and their governments who are in charge of regulating financial matters—Therefore, the issue of Islamic banking and finance is of great interest to the millions of Muslims who have migrated in the last twenty-five years to the West, where they are living as economically successful minorities in Europe, the United States and Canada".

> Another Canadian official expressed similar sentiments. In January 1998, Leopold Battel, Deputy Director, Export Financing at the Department of Foreign Affairs and International Trade stated: "Islamic banks are becoming resourceful. The Canadian banking industry, and the Canadian business in general, will need to quickly adapt to this trend at the risk of being left out of a lucrative sector and probably a major mode of financing in a market".

In view of the growing Muslim population, increasing financial resources and a positive political atmosphere, the establishment of an Islamic bank in

Canada does not seem to be far off. In the meantime Canada Muslims, while operating within the Canadian economic system, have found innovative means to observe the Islamic laws of interest-free banking by doing business in other ways.

The Islamic Housing Cooperative, based in Toronto, with assets of $25 million, and the Qurtaba Housing Society, based in Montreal, enables members to take a mortgage on a house without paying interest. And a new complementary Halal Housing Corporation is in works to meet the growing demand for interest-free house finance. Similar initiatives are being tried on consumer's loans and other commercial transactions. For example, in Toronto, Ansarco and Al-Amin are managing the savings of Muslims in Ijara based Car leasing and Murabaha/Mudaraba based investments, in real estate etc. In Montreal, the Al-Lttehad Investment Company has similar car leasing and computer based investment.

Furthermore, the stable investment climate in Canada has an appeal for international investors.; The presence of Islamic financial institutions in Canada would further act as an inducement to funkier develop the trade between Muslim countries and Canada.

The committee on financial institutions also considered launching an Equity fund. Equity funds are the most natural fit for Islamic investments since Islamic financial principles. These funds encourage productive allocation of economic resources, equity participation and sharing of risks. Global privitization is providing tremendous opportunities for the growth and devdopment of Islamic equity funds.

The introduction of innovative products such as islamic equity funds still remains to be the real challenge for Islamic banking in Canada. Successfully meeting this challenge will determine the viability and sustainability of Islamic financial market in Canada and Ontario.

It is important to note the way Muslims have adapted to Canada and the manner in which Canada is adapting to them is a tribute to both Canada and Islam. Canada has had an honorable history of accommodating and welcoming new religious minorities.

Currently, there are 56 foreign banks operating in Canada, yet not a single bank is form any Arab or Muslim country. This situation will certainly change in the future because Muslim presence in Canada is permanent and it is growing.

Emergence of Takaful Worldwide: From Mid-East To Malaysia To USA

By

Omar Clark Fisher *

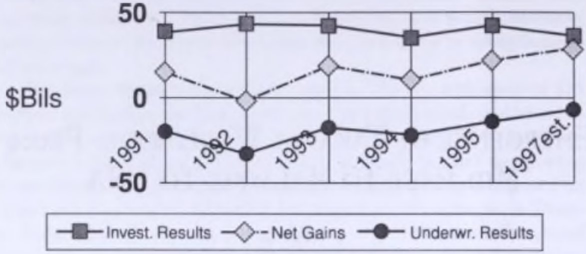
Conventional Insurance. Trends and Scope

Insurance globally is a gigantic industry with activity exceeding $2 trillion dollars in premiums annually. In the United States, insurance is among this nation's largest industry with more than S600 billion in premiums annually, of which $277 billion were property and casualty in 1996 [up 3.4%]. Net income was 536 Bil with claims of $110 bil [vs. $198 bil in '95]. Catastrophic losses were reduced as no serious disasters struck like Hurricane Andrew of 1992 - $16 bil or the LA earthquake in 1994 - $11 bil. Among the key trends are movements towards alternative risk management, increased risk retention, self-insurance and formation of captive insurance entities. Altogether these alternative insurance forms represent 43% of the insurance market vs. 40% just three years ago.

Other significant trends are: outsourcing paperwork like claims adjusting and policy issuance strategic risk financing rather than risk transfer, multi-year policies and disintermediation whereby the clients are seeking to purchase insurance directly from insurers rather than through brokers or agents. For example, the Internet is estimated to account for over $2 bil in insurance premiums sold by 2000. Another significant trend is the securitizition of insurance risks. Similar to the bundling of mortgages, credit card debts or auto leases, homogeneous insurance risks can be packaged and sold to investors in the form of securities.

The following table shows the financial results of the insurance industry over the past six (6) years.

* Omar Fisher is CEO of First Takaful USA



The Takafill Alternative

The historical roots of Takaful 14 centuries ago lie with the widely practiced Arab customs af a pre-Islamic era that were adopted by Prophet Muharnmed (PBUH) as acceptable practices. Chief among these were:

- Surety called "Daman Klatr Al-Tariq"
- Tribal Assistance after killings—A'Qila
- Mutual contracts—Aqd Muwalat
- Confederations for mutual assistance-Hilf
- Other pre-Islamic customs approved by Prophet Muhammed (PBUH) based upon Concept of "Ta'awun", or mutual assistance and self-help.

Fundamental precepts are set forth in the Holy Qur'an [Sura Al Maida V 3/4] and the Sunnah concerning the spreading of risks to individuals across the community. These principles were incorporated into the operations of modem-day Takaful insurance companies that were "re-discovered" during the early 1980s. The first such company was created in Sudan, called the Islamic Insurance Company, followed quickly by Takaful companies in Saudi Arabia, Bahrain and Malaysia 1983-85. Generally, these companies have operated within their own national boundanes and have not yet accomplished much product innovation. Although these companies are privately-owned and do not publish regularly financial data, we can form a profile of the global Takaful Operators as an industry (as of 1996), excluding Takaful saving funds:

- 27 Takaful Companies in 16 Countries
- Paid Up Capital approximately $225 Mil
- Total Assets 5400 Mil ('96)

- Gross Premiums $330 mil ('96)
- Industry less than 15 Years New
- Limited within National Boundaries
- Early Phase of Product Introduction

Characteristics of Takaful Model

From an examination of the various Takaful models in operation, we can observe that the preterrea model in the Middle East is the Non-Profit Model used in Sudan which is based upon an Al Mudarabah contract between the Takaful Operator and the Insured. The preferred model in the Pacific Rim is the For-Profit Model which as used in Malaysia also based upon an Al Mudarabah contract. One key difference is that in the latter model, the Takaful Operators shares (as a Mudarib) in the investment income earned from the investment of premiums and also shares in the annual surplus from operations, if any by contrast the policyholders in the Non-Profit Model typically give their premiums as a donation and do not expect any investment returns or distribution of annual surplus.

There are four (4) fundamental characteristics of a Takaful Operationss. Each one is necessary to create an integrated Takalul:

Specialty Condition: Joint-Guarantee. Common Risk Sharing
Partnership Condition: Profit-Sharing, Self-sustaining Operations
Investment Condition: Halal Investments. Profit-motivated, Islamic Contracts

Management Condtiion: Insureds participated in Management and review Books & Accounts

Among the major characteristics that differentiate convenional insurance operations from a Takaful, are the following:

- Separation of Insurer (company) and insured (policyholder)
- Transfer of Losses using Limited Ownership and Proprietary Interests
- Enterprise exists for the Maximization of Profits
- Commercial Transaction with investment of Premiums using *Riba* and Non-Islamic Securitie
- No Involvement/Influence by Policyholders in Management af enterprise (except in mutual insurer)

Why is an Islamic Alternative to Conventional Insurance needed in USA? Modern society in USA requires Insurance for Autos and Businesses,

Schools, Islamic Centers and Mosques open to Public. As Muslims, we seek to follow *Holy Qu'ran, Sunnah and Shariah* rules which allow Takaful (cooperative insurance). There is *no Takaful* available in USA or Canada tody.

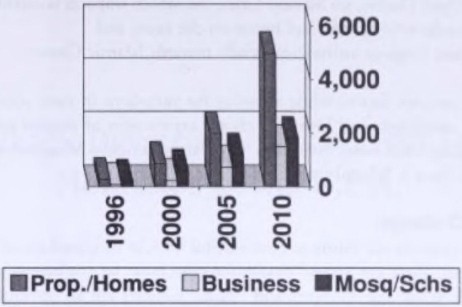
What makes Conventional Insurance objectionable? Most Commercial Insurance involves gambling (Al Maisir)—especially Life. Most Insurance contains uncertainty and lack of clear terms (Al-Gharar). All Insurance involves interest charges and Debt investment instruments (Al-Riba). Most Commercial Insurance seeks Profit maximization not Well-being of Insureds.

By contrast, the key elements of a Takaful are:
Solidarity and Joint-Guarantee; e.g. Cooperative.
Risk sharing.
Joint ownership.
Investments in Halal financial products.
Overall Self-reliance and Self-sustaining characteristics.

As a case profile, we might look to two religious-based insurance entities which have operated in the U.S. for more than 40 years; namely (1) the Church Insurance Company, founded in 1929 (NY) with initial capital of $15 million. CIC has a Best Rating of B++ and collects Premiums annually of $28.6 mil ('95) with Admitted Assets of $77 mil.; and (2) Catholic Relief Insurance, founded in 1955 (NEB) with an initial capital of $2.5 mil. CRI has a Best Rating of A- and collects Premiums annually of $6.9 mil ('95) with Admitted Assets of $16.2 mil.

The future demands for Takaful insurance in the United States will be driven by population growth within the Muslim Community estimated to be approximately 6-8 Million in 1998. By the year 2010, the Muslim population may swell to 10 Million and may become the third largest minority in USA. Demand for Takaful insurance will also be strongly affected by the growth in religious buildings, especially Mosques, Islamic Centers and Islamic Schools Today there are 1850 Islamic Centers across USA, Islamic Schools and three Islamic Universities all own assets, property and buildings that are currently substantial Takaful commercial insurance operations.

The following Chart shows the estimated Exposure Values of key properties owned by the Muslim Community [Homes, Businesses and Mosques and Schools] projected out 12 years. When combined, these values exceed $8 Billion dollars.



Role of Takaful USA

Although First Takaful USA is a young program seeking to address the insurance needs of the Muslim community nationwide, it has succeeded in bringing a range of insurance services to market with the cooperation of Reliance National, the 24th largest commercial property-casualty insurance company in USA with assets of $11 Billion

Among the coverage's it currently provides are:

- Commercial Policy Package
- BOPs
- Commercial Property (Boiler/Machinery/Inland)
- Commercial Transportation (limos/taxis!/"black cars"/bus)
- Workers Compensation
- Casualty Programs
- Umbrella Liability
- Excess & Surplus Lines

While there are many advantages of applying the Takafill principles to modern insurance conditions, we can identify four (4) main benefits to an insurer which uses the Takafhl system:

(1) the Unity of Insurer due to their shared interests;
(2) lower "Moral" Hazards;
(3) underwriting risks are geared to Muslim Businesses, Religious Buildings and Property which have little or no Liquor Liability, no

Open Flames, no Stained Glass, etc. which impacts favorably on the underwriting risks and hence on the rates; and

(4) non Litgious attitude-especially towards Islamic Centers.

These positive factors while allowing for variations in rates according to the local conditions and historical claims experiences of various companies still translate into lower premium rates for practicing Muslims who seek insurance fonn a Takatul company.

Future Challenges

As we examine the future of First Takaful USA in its introduction of Takaful services, there are several challenges that must be confronted and surmounted. While the Mosques and Islamic Centers are an obviously target for marketing Takaful services, most Islamic Centers are managed by volunteers or part-time personnel. The lack of full-time management of Mosques/Islamic Centers will be an inhibiting factor in the adoption of Takaful insurance to protect these religious buildings. Likewise an absence of centralized management and a lack of linkages among national Muslim organizations will hamper the endorsement of Takaful insurance as the right principle of insurance. Next there seems to be a popular skepticism about Islamic Financial Services among the general Muslim population. Specifically, we have observed inertia towards embracing Takaful because most Muslims have not direct experience with or knowledge about Takaful. When something is unfamiliar, many people may be reluctant to change from their "comfort zone". However, the Believers are enjoined to follow the guidance of the Holy Qu'ran and Sunnah, which sets forth the basic tenets of mutual self-help and risk protection (Takaful). In addition, we will be challenged by the contemporary regulatory environment and other barriers to entry into the highly competitive and capital-intensive insurance industry. Finally, we face the substantial high costs of advertising and promotion of insurance services nationwide in order to reach out to the edges of the Muslim Community from Boston to San Diego.

Issues in Developing an Interest-Free Mortgage in the U.S.A.

By
*Abdullah Yavas**

I. Introduction

Approximately two-thirds of the residential properties in the U.S. are owner-occupied and they represent almost $7 trillion in value. Housing is the single biggest investment, and mortgage[1] payment is the single biggest monthly liability of a typical household. Since purchasing a house requires a large amount of investment, a typical buyer borrows a big percentage (up to 95%) of the purchase price. As a result. almost 45% of the total value of owner-occupied homes are currently owned by mortgage lenders (see Figure 1) and the total value of mortgage loans for owner-occupied homes exceeds three trillion dollars.

Given that there are close to six million Muslims in this country, it is safe to argue that there is a substantial market for interest-free mortgage loans. Average residential mortgage loan in the top 200 metropolitan areas in 1996 was $94,150.[2] If we assume that 100,000 households would be interested in an interest-free mortgage instrument, that amounts to a total mortgage demand of $9.415 billion in value. Unfortunately, the supply side of the market has not fully developed yet. There is a very limited number of interest-free mortgage alternatives, such as those offered by the MSI Finance and American Finance House, and most of the Muslims in this country do not have an access to or are not even aware of these alternatives.

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* Abdullah Yavas is associate Professor of Business Administration, Penn State Univesity, University Park, PA.

1. A mortgage is a debt contract between a borrower and a lender whereby the borrower pledges real estate as the security for the loan. Throughout the paper, the term mortgage will also be used to refer to interest-free financing arrangements between banks and homebuyers.

2. Republic Mortgage Insurance Company (1998).

There are various reasons why the development of a market for interest-free mortgages in the U.S. has been very slow. A major reason is that designing an interest-free mortgage for the U.S. is a complicated challenge. The U.S. has a well-established interest-based mortgage market both at the primary and the secondary level. A homebuyer has a large number of alternative mortgage types to choose from (fixed rate mortgages, adjustable rate mortgages, shared appreciation mortgages, graduated payment mortgages, etc.), with different point and interest rate combinations[3], and with different terms of up to thirty years. A qualifying buyer will not have much difficulty in finding a mortgage loan that suits his/her needs. Such a rich variety of mortgages makes it harder to design an interest-free mortgage instrument that can compete with all the existing offers in the market.

The problem is further complicated by tax concerns. As with any investment, taxes play a crucial role for the attractiveness of a mortgage to the bank and to the homebuyer, because both parties are interested in their *after*-tax returns. Unfortunately, there will likely be some tax disadvantages associated with interest-free mortgages. For instance, a major benefit of borrowing for a home purchase is that the borrower's interest payments on the mortgage loan are exempt from taxes. Such a benefit will obviously not be available to interest-free mortgages under the current tax law.

Another potential concern is that profit-loss sharing arrangements of interest-free mortgages may create some adverse selection and moral hazard problems, such as attracting high-risk homebuyers and not providing enough incentives for homebuyers to expend the optimal amount of maintenance and repair.

The purpose of this study is to examine the tax concerns, incentive problems and critical issues surrounding the design of an interest-free mortgage, both from the perspective of lenders and borrowers. The focus will be on owner-occupied residential mortgages. Although some Muslim homebuyers would never take out an interest-based mortgage, the paper is based on the premise that the success of an interest-free mortgage depends critically on how financially attractive it is vis-a-vis the existing mortgages in the market

The next section of the paper discusses some of the potential challenges for an interest free mortgage. Section III points out to the tax benefits of homeownership in general, and interest-free mortgages in particular. Section IV provides an analysis of the competition to be faced by interest-free mort-

3. Points are a type of loan fee charged by the lender at the origination. A point corresponds to 1% of the loan amount. A loan with higher (lower) points will have a lower (higher) interest rate.

gages. Section V offers some suggestions for maximizing the tax benefits of an interest-free mortgage to the bank and the homebuyer. Section VI concludes.

Potential Challenges

There are a number of challenges that an interest-free mortgage instrument will have to deal with. Some of these challenges apply to any mortgage type while others apply specifically to interest free mortgages. The following is a list of potentially critical issues.

Banking Regulations

Banking regulations in the U.S vary from state to state. As an example, the ability of a bank to open multiple branches differ widely across states. While some states allow statewide branching, some of the Midwestern states only allow unit banking, i.e., single-office institutions primarily serving their local communities.[4] A more important complication associated with state-specific regulations is that lenders are subject to the laws of the state in which the borrowers reside. Therefore, if a bank in New York serves borrowers from different states, then the bank will be subject to different laws in dealing with borrowers from different states. Such regulations complicate a bank's ability to do business across states. This may restrict the activities of interest-free banks to states with a high density of Muslim populations.

Tax Benefits can be Damaging for Interest-Free Mortgages

As mentioned earlier, buying a house is the single biggest investment for a typical household. As with any other investment, the homebuyer will pay close attention to the expected return and risk associated with buying a house and the method of financing it An important factor for the expected return is the taxes to be paid; investors care about their after-tax returns rather than their before-tax returns. From this perspective, an interest-free mortgage should strive to minimize the tax liability as much as possible.

The major financial challenge for interest-free mortgages is that the interest part of a mortgage payment is tax deductible in the U.S. This tax benefit is considered by homebuyers as one of the primary benefits of borrowing. Consider a homebuyer who is in the 28% tax bracket. The ability to deduct mortgage interest payments reduces this homebuyer's mortgage interest rate

4. Hempel, Coleman and Simonson (1990), pp. 8-10. A comprehensive description of the regulatory structure for banks can be found in Part 10 of the Bankers Handbook (1978) and in Bank Supervision (1988).

by 28%. This can pose a threat to the success of an interest-free mortgage instrument because, by definition, interest-free mortgages will not have an interest component. In order for an interest-free mortgage to be as attractive as a standard mortgage, it needs to offer the homebuyer a lower rate / cost of borrowing or alternative benefits to compensate for the loss of this tax benefit. As an example, consider the case where a typical mortgage is offered in the market at an annual interest rate of 10%. An interest-free mortgage needs to be designed such that the cost to the borrower is around 10%*(1-28%) = 7.2%. In other words, while a typical mortgage lender earns 10%, ceteris paribus, an interest-free mortgage lender would have to be satisfied with 7.2% to be fully competitive.

One partially countervailing factor to this tax challenge is the recent Roth IRA (Individual Retirement Account) program. Earnings in a Roth IRA are exempt from federal taxes. More importantly, individuals will not owe any federal income taxes or penalties on the assets they withdraw from their Roth IRA accounts if they use the withdrawal to help pay for a qualified first-time home purchase. In other words, the equity financing of a first-time home purchase through a Roth IRA enjoys the same benefits as the debt financing. Note, however, that this is a partial solution: it applies to first-time home purchases only, not every homebuyer would have a Roth IRA account, and the tax deductible amount is likely to be far less than the amount deducted under an interest-based mortgage.

Another factor that may mitigate some of the tax disadvantages of interest-free mortgages is the fact that a house is a consumption good as well as an investment good. People derive utility from simply owning a house as well as from its monetary returns. This consumption value of real estate may diminish the importance of the investment aspect, thus reducing the significance of the tax benefits of home ownership for some potential buyers.

It is worth noting that the tax benefit/problem is not an issue in Canada or England where interest payments are not tax deductible. There would seem to be little economic or social justification for favorable tax treatment of debt over equity financing in the U.S. One potential explanation could be the political power of financial institutions in this country. Finance, Insurance & Real Estate industry is the second biggest contributor—after the labor unions- to the political parties (Khoury, 1997).

Due to social and political motives, governments like to increase the ratio of homeowners in the country. As a result, a number of government programs and subsidies have been established to help families to own a house. Given this, I believe it is quite plausible to develop the appropriate language and framing logic to convince Congress to allow a tax deduction for inter-

est-free mortgages (e.g, a tax-deduction for the rent part of an interest-free mortgage payment).

Another Tax Problem

Purchase and sale of real estate is subject to transfer taxes. The magnitude of these taxes varies from county to county. Conventionally, this tax is paid by the homebuyer upon the purchase of the property.

Under a typical interest-free mortgage, the bank and the homebuyer co-own the property (as "tenants in common") and the bank's share is eventually transferred to the homebuyer.[5] Thus, there are two transfers taking place; the first when the property is purchased, and the second when the bank's shares are transferred to the homebuyer. As a result, the homebuyer and/or the bank pay the transfer tax more than once. To illustrate, suppose the bank supplies 80% of the $150,000 purchase price, the homebuyer comes up with the remaining 20%, and the transfer tax is 1% of the sale price. The homebuyer and the bank together will pay $1,500 in transfer taxes at the time of purchase. Through time, the bank's 80% share will be transferred to the homebuyer. In Centre County, PA, this will result in additional $450 (50%* 80%*$1,500) in transfer taxes.[6]

Risks Involved

There are two criteria to evaluate an investment; expected return and risk. These criteria apply to an interest-free mortgage as well because such a mortgage constitutes an investment for both the bank and the homebuyer. Potential sources of return for the bank include rent receipts, bank's share of the appreciation in the value of the property and service fees Potential sources of return for the homebuyer include his/her equity in the property, his/her share of the appreciation and tax benefits. The terms of the contract, such as the rent amount, the profit/appreciation sharing rule between the bank and the homebuyer, mortgage origination fees and other charges by the lender will obviously be pivotal in determining the expected return for the lender and the homebuyer.

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5. Examples of this practice in the U.S include MSI Finance Corporation's "SHARE" program (see Aijazi, 1992) and American Finance House's "LARIBA" program (see their web site http:flwww.americanfinance.com/site6.html).

6. The 50% is due to the fact that the property was co-owned by the bank and homebuyer prior to the transfer. Transfer taxes are much higher in some of the Muslim countries. My conversations with two of the Islamic Banks in Turkey (Al-Baraka Turk and Asya Finans) revealed that transfer taxes are their primary reason for not offering interest-free mortgages in Turkey.

Riskiness of a mortgage, on the other hand, refers to the possible fluctuations in the return from that mortgage. Some of the risk is related to the characteristics of the borrower and mortgage instrument while some of it is due to changes in the market conditions. The following factors are crucial in determining the risk for the two parties.

Default Risk: The biggest risk element for a bank is that the homebuyer fails to make the payments in some future period. A homeowner defaults on his/her payments for two reasons. One is that either the homeowner's income falls (due to loss of a job, divorce, etc.) or the homeowner's expenses rise (due to increase in the number of children, unexpected health costs, etc.) so that he/she can no longer make the payments specified in the contract. The other reason for default is that the market value of the house falls significantly below the loan balance (the amount that the homeowner owes to the bank). In this case, the homeowner may choose to default even though s/he can afford to make the mortgage payments.[7] The reason is that if the homeowner defaults s/he loses the house, but the house is worth less than what she owes to the lender. Thus, by defaulting the homeowner earns the difference between the mortgage balance and the market value of the house. Obviously, since default is costly for the homeowner (bad credit rating, the time and effort the default process takes, social and psychological pressures, etc.), s/he will choose to default only if the difference between the mortgage balance and the market value of the house is bigger than his/her cost of default.

Default results in significant losses for the bank. Although the bank will be able to foreclose the property and sell it at a public auction, the receipts from such a sale are almost never large enough to recoup all of the bank's losses.[8] The actions that the bank can take in the case of a default vary from state to state and will determine the bank's expected default losses. For instance, some states require the bank to go through a costly and time-consuming foreclosure process (judiciary states) while others make it simpler for the bank to conduct the foreclosure sale (title-theory states). Similarly, some states allow for deficiency judgements (the right of the bank to go after the homeowner's personal assets), while other states do not.

Market risk: Market risk refers to unexpected fluctuations in the demand for and supply of interest-based and interest-free mortgage instruments,

7. Such default is referred to as *strategic default*.

8. If the value of the property were high enough to cover the loan balance, then the homeowner would not have defaulted because s/he could have sold the house in the market, payoff the loan from the sale proceeds, keep any extra amount left, and avoid all the costs of default..

fluctuations in the market interest rates and prevailing rent/profit sharing rules, and fluctuations in the value of the collateral property. As mentioned above, the last item is also important for the default risk.

Another dimension of the market risk is related to the fact that real estate is a highly localized asset. That is, the current and future value of a real estate depends on the town, even the neighborhood, in which it is located. As a result, the assessment of a real estate investment requires a careful study and understanding of the market forces in that locality. Yet, it is a very costly and complicated process to gather the data and have an accurate assessment of the expected return and risk of real assets in different locations. This makes it more difficult for a bank to finance the purchase of a real estate in different towns or states. This is a part of the reason why a typical mortgage lender usually serves its own local market only.

This problem is more severe for income producing properties than it is for residential properties. The concern for financing residential properties is a decline in the homebuyer's income or a drop in the value of the property, either of which can cause a default. The concern for financing of income properties, on the other hand, is a less-than-expected rental income (which is the primary source of mortgage payments for the investor) or a drop in the value of the property. Therefore, the bank needs to have accurate projections for not only the value of a commercial property but also the cash flows from the property in future periods.

In addition to local and regional factors, property values and rent levels are also correlated with national economic policies and conditions. For instance, an increase in the interest rates by the Federal Reserve or a recession in the economy is likely to cause a drop in property values and rent levels across the country, which in turn causes a decrease in the appreciation return and an increase in the default rate.

Legislative risk: Real estate markets are subject to a variety of rules and regulations that change from time to time. A change in these rules and regulations in the future may directly and indirectly affect the risk and return of a mortgage instrument. A good example is the recent environmental regulations, such as the Superfund Act, which resulted in unexpected and sign)ficant losses for many investors and mortgage lenders.

Adverse Selection

Another major concern for an interest-free mortgage institution is the kind of homebuyers that its mortgages would attract. Obviously, some homebuyers would choose an interest-free mortgage simply because it is interest-free. However, some (and I suspect most) homebuyers, Muslim or

non-Muslim, would choose an interest-free mortgage because they find it more attractive than the interest-based mortgages in the market. The adverse selection issue is a concern with the latter group: would an interest-free mortgage attract high-risk or low-risk homebuyers? Therefore, would an interest-free mortgage have an above-average or below average default risk?[9] A study by Kazarian (1993), for instance, finds a high rate of default (60%) for the Faisal Islamic Bank of Egypt and the Islamic International Bank for Investment and Development.

Moral Hazard

The value of a property is highly correlated with the maintenance provided for that property An interest-based mortgage gives the full ownership of the property to the borrower. Further, the borrower receives the full amount of appreciation/depreciation in the value of the property. This provides the borrower with the right incentives to spend the optimal amount of effort and money on maintenance and repairs because the borrower receives the full benefits of such spending An interest-free mortgage, on the other hand, is likely to have a co-ownership between the bank and the homebuyer (at least until the homebuyer makes a certain amount of payment to the bank), and the bank is likely to participate in the appreciation/depreciation of the property. In this case, the buyer receives only a part of the benefits (proportional to his/her share of the appreciation) from his/her spending in repairs and maintenance. Since the homebuyer incurs the whole cost while receiving a part of the benefits, he is likely to spend less than the optimal amount on repairs and maintenance.

The co-ownership creates another type of a moral hazard problem. If the property is sold before the homeowner assumes full ownership, then the bank has a "monitoring" problem in the determination of the value of the property. When the bank and the property homebuyer are in two different towns, the bank has to rely on an appraiser from the town the property (hence homeowner) is located in. Since the bank and the appraiser are in two different towns while the homeowner and the appraiser are in the same town, the bank needs to make sure that the appraiser's value estimate will not be biased towards the homeowner's interest.

The source of the moral hazard problem is due to the bank's participation in the appreciation. The solution would simply be to let the home-

9. This issue was recently examined for the borrowers' choice between a Fixed Rate Mortgage (FRM) and an Adjustable Rate Mortgage (ARM) in a theoretical study by Posey and Yavas (1998). It is shown that high default risk borrowers are more likely to choose an ARM while low risk borrowers are more likely to choose an FRM.

owner receive the full appreciation and, if necessary, adjust the rent to compensate the bank for the lost appreciation benefit. This can be accomplished by fixing the price, thus amortization payments, at which the homebuyer could purchase the house from the bank.

On the other hand, it is a well-known economics principle that if the homeowner is risk averse and if there is a risk of depreciation, then sharing the appreciation/depreciation provides a more optimal risk sharing. However, since the house prices are expected to increase in the long run, the risk-sharing benefit may not be enough to cover the moral hazard costs.

Opportunities

The Biggest Tax Benefit of Home Ownership

The biggest tax benefit of home ownership is not the exemption of mortgage interest payments. Instead, it is the fact that imputed rents are not taxed. In other words, the rent payments that the homeowner saves by owning the house rather than renting it are totally tax free. To exemplify this tax benefit, suppose that you purchase a $100,000 house all in cash. Assume that the market rent for similar houses is $900/month. That is, you save $900/month by owning the house instead of renting it. In other words, your $100,000 investment in the house is earning you $10,800 (10.8%) a year, and yet you do not have to pay any taxes on this return.[10] If you invested this $100,000 on stocks, bonds or other assets, or if you used it to purchase the same house to rent it to a tenant, then your income would be taxable. Assuming 28% federal tax bracket, 3% for state taxes and 1% for local taxes, your 10.8% return would then be reduced to 10.8%*(1-32%)=7.344%. This is a clearly significant tax benefit to home ownership.

Another major tax benefit of home ownership is related to the capital gains. Following rent savings, appreciation in the value of the house is the second biggest source of return for homeowners. Although it is possible for real estate prices in an area to fall, they generally tend to increase over time. As with capital gains from other assets, capital gains from the sale of a house are also subject to taxation. However, the tax law offers opportunities for homeowners to defer and eventually eliminate their capital gains tax. For instance, the "rollover rule" says that if the seller of a home buys or constructs another residence of equal or greater value within 24 months before

10. The maintenance, insurance and other expenses of a house are not deductible from taxes. Once these costs are accounted for, it is estimated that the return to home ownership due to imputed rents is likely to be in the range of 6% to 8%.

or after the sale, then the seller's gains are not taxed in the year of the sale. Instead, the gains are rolled over to the new residence purchased. There is no limit on the number of times a homeowner can utilize this tax benefit during his/her lifetime. A second tax rule, the "age-55and-over exclusion" rule, exempts capital gains of up to $250,000 from tax if the seller is age 55 or over. Therefore, a homeowner can defer all of his/her capital gains tax by using the rollover rule repeatedly and then eliminate the accumulated taxes by using the age- 55-and over rule.

Note that these two tax benefits are independent of the way the home purchase is financed. They relate to homeownership, not to mortgage payments. Thus, a homebuyer can enjoy these benefits even if he pays for the house in cash. However, since most families cannot afford to purchase a house in cash, they will not be able to enjoy these tax benefits unless they obtain financing. Therefore, these tax benefits of homeownership, coupled with the fact that most households have to borrow to purchase a home, will be the primary source of demand for interest-free mortgages.

A Tax Benefit for Interest-Free Mortgages

Although the inability to enjoy tax-deductible interest payments is a major drawback for an interest-free mortgage, there is a tax benefit that applies to interest-free mortgages but not to interest-based mortgages. This tax benefit relates to depreciation. The current tax law allows a residential property to be depreciated over 27.5 years and a non-residential property over 39 years. In other words, the owner of a residential property can deduct an amount equal to (building value / 27.5) each year as depreciation expense. The key, however, is that while the owner of a rental unit enjoys this tax benefit, a resident-owner is not allowed to have it. Since the residents owner has the 100% ownership of the house under an interest-based mortgage, this tax benefit goes unutilized. Under an interest-free mortgage, on the other had, the bank co-owns the property and acts like a landlord. Thus, the bank can deduct its share of depreciation from its taxable income and this benefit to the bank is generated at no cost to the homebuyer. The bank, in return, can pass a part of these tax benefits to the homebuyers and make the mortgage financially more attractive.

A related tax issue concerns the spending on repairs. Repairs are not tax deductible for resident-homeowners. However, the bank, acting as a non-resident co-owner, can write off repairs to the extend that it pays for them. The same rule applies to insurance premium payments and, if the property is a condo or a townhouse, the monthly association fees. These tax rules should be taken into consideration in deciding who pays for Which of these expenses.

The Competition

Can an interest-free mortgage institution offer mortgage instruments that are financially as attractive as, or more attractive than, the interest-based instruments available in the market? Unfortunately, the most likely answer is no. There are thousands of financial institutions in the market who are constantly searching for ways to make their products more attractive to potential homebuyers. Any mortgage instrument that is currently available to an interest-free bank has been available to interest-based banks for a long time. Therefore, one can infer that the intereste based mortgages are more attractive to homebuyers than interest- free mortgages. Otherwise, some banks would have included interest-free offerings in their portfolio of products.

The only residential mortgage in the market that slightly resembles a non-interest mortgage is the Shared Appreciation Mortgage (SAM). With a SAM, the lender offers a lower interest rate in return for receiving an agreed upon percentage of the appreciation in the value of the home.[11] " The payment to the lender for price appreciation is due after a specified number of years or whenever the home is sold, whichever comes first. If the home is not sold by the end of the specified number of years, an appraisal is made to determine the market value, hence the amount due to the lender.

Given that conventional banks in the market today chose not to offer any interest-free mortgages, it can be argued that an interest-free mortgage will be appealing only to (a subset of) the Muslim homebuyers. However, as pointed out in the introduction, this subset alone can be a significant market. Although Muslims are spread across the country, the fact that an interest-free mortgage will be more of a partnership than a loan contract, regulatory hurdles for interstate lending may not be a serious concern. However, the fact that a subset of Muslims would never take out an interest-based mortgage does not mean that they will jump at any interest-free mortgage offering. Even though this group would avoid interest-based transactions at all cost, their demand for an interest-free mortgage will be directly related to its attractiveness because of two alternatives available to them: one is simply not to buy a home and remain as a renter, the other is to purchase the home from the seller on an installment base. The latter is already commonly used in the market under such terms as *Purchase Money Mortgage* and *Land Contract*. Although these are two forms of seller-financing and involve interest payments, the language of the contract can be reconstructed so that the interest payments are replaced with rent or installment payments.

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11. SAMs are generally used for home purchases. The corresponding mortgage for income properties is known as Equity Participation Loan where the lender participates in the income and appreciation from the property.

Another challenge for an interest-free financial institution will be on the supply side of the funds. A major source of funds for interest-based mortgagees is the secondary mortgage markets. Banks can sell their mortgages to the investors in the secondary mortgage markets[12] as long as the loans confirm to certain standards (such as satisfying certain requirements for the loan-to-value ratio, income-to-mortgage payment ratio, etc.). These mortgages are often pooled together, and bonds and securities are issued against these mortgage pools. These bonds and securities can then be purchased in stock markets by individual and institutional investors. Currently, more than half of the one- to four-family residential mortgages (about $2 trillion in value) are held in mortgage pools and are securitized. It is clear that the secondary mortgage market plays a critical role of replenishing funds used by mortgage lenders by reaching broader investor markets. Since an interest-free mortgage will not, under the current practice, confirm to the standards of secondary mortgage markets, it will not be possible to sell them in those markets. Therefore, an interest-free mortgage originator has to rely on deposits from its own customers to fund the requests by homebuyers and investors. This supply problem is evident in the currently available interest-free mortgages in the U.S. from the fact that the originators (e.g., MSI Finance Corporation and American Finance House) usually require those who seek financing from them to have a deposit with them for a certain number of months.[13]

Finally, interest-based mortgage lenders require the borrower to purchase mortgage insurance if the loan amount exceeds 80% of the purchase price. This insurance provides protection for the lender against some of the potential default losses. Since the interest-free mortgage will be a partnership between the bank and the homebuyer, such insurance may not be available to interest-free banks. This increases the expected default loss for the bank. To compensate for the increased risk, the bank may require a higher rent and a larger share of the: appreciation. Meanwhile, the absence of mortgage insurance eliminates the premium payments for the homeowner.

Suggestions for Designing an Interest-Free Mortgage

There are two ways of structuring the co-ownership of the property bank

12. Major investors in the secondary mortgage markets include FNMA (Federal National Mortgage Association), FHLMC ("Freddie Mac" or Federal Home Loan Mortgage Corporation, GNMA (Government National Mortgage Association), life insurance companies, pension funds and other long term investors.

13. It is possible that this deposit requirement also acts as a device for the bank to screen out applicants with higher default risk.

and the homebuyer under an interest-free mortgage. One is to structure it as a *limited partnership*, the other as a *tenancy in common*. For tax purposes, tenancy in common is more advantageous than limited partnership. The main reason is that participants in a partnership cannot roll over their capital gains into a tax-deferred exchange when the property is sold. Therefore, the tax on any gains has to be paid within the same tax period. On the other hand, all parties under tenancy-in common ownership can defer the capital gains tax provided that they purchase another home of equal or greater value within 24 months.

The design of an interest-free mortgage should also consider the allocation of the income between capital gains and ordinary income. The aim should be to assign most of the gains as capital gains to the homeowner. There are two reasons for this: one is that capital gains tax rate is capped and therefore is usually lower than the income tax. The second, and more important reason is that, as discussed earlier, homeowners can completely avoid capital gains tax by utilizing the "rollover" rule and "age-55-and-over exclusion" rule.

Under the current conventional practice, the Islamic bank purchases the house and leases it to the homebuyer. In addition to the rent, the homebuyer also pays a part of the purchase price to the bank each month and eventually assumes the ownership of the house. It is not clear if this is the optimal structure for the bank: it might be better for the bank to sell the house to the homebuyer on an installment-base.[14] Under the current rent arrangement, the rent receipts of the bank are taxable while the rent payments of the homebuyer are not tax-exempt. Furthermore, rent receipts are considered as income and subject to income taxes. Under the installment sale, the installment receipts could be considered as capital gains tax and would be subject to capital gains tax. Under the current law, the capital gains tax rate is capped at a maximum of 28% whereas the income tax rate can be as high as 39.6%. Furthermore, similar to the "rollover" rule, bank may benefit from the "like-kind exchange" rule which would allow the bank to defer tax payments on capital gains.

The two most popular interest-based mortgage types in the market today are fixed rate mortgages (FRMs) and adjustable rate mortgages (ARMs). The interest rate and the monthly payments under an FRM are fixed at the time of origination for the duration of the mortgage. Under and ARM, on the

14. Installment sale is in practice very similar to the Purchase Money Mortgage. The only difference is with respect to labeling; the payments under an installment sale will have amortization and profit components while the payments under a Purchase Money Mortgage have amortization and interest components.

other hand, the interest rate and the monthly payments are adjusted periodically (every 6 or 12 months) according to a pre-determined market index. The principal distinction between the two mortgage types is the way they allocate the interest rate risk between the homebuyer and the bank. Under an FRM, the homebuyer is guaranteed the interest rate, thus the bank bears all the risk of fluctuations in the market interest rates. Under an ARM, on the other hand, the homebuyer bears most of the interest rate risk because of the periodic adjustments. As a result of their higher risk, the ARM rates tend to be lower than the FRM rates.

An interest-free mortgage can also be designed so that the payments are either fixed (FPM: Fixed Payment Mortgage) or adjustable (APM: Adjustable Payment Mortgage). Obviously, given their risk aversion, homebuyers would prefer an FPM over an APM unless the present value of the expected payments under the APM are lower. On the other hand, APMs allow the bank to keep their rents up with the market. The impediment, however, is that it would be very difficult to have an "objective" determination of the market rent rate under an APM. Real estate is an heterogeneous product. No two houses are exactly identical. Furthermore, there are very few houses that are rental (this is less of a problem with condominiums). As a result, it will be almost impossible to tie the rent adjustment to some market index of rents. An alternative is to adjust the rents to the inflation or housing price index. It is not always true, however, that rents will have the same fluctuations as the inflation or the housing price index.

A more appealing alternative to FPMs would be a GPM (Graduated Payment Mortgage). As in the case of a FPM, the rents under a GPM will also be fixed at the time of mortgage origination. However, instead of remaining at the same level throughout the mortgage term, the rents under a GPM will be increased at a pre-determined rate for a pre-determined number of years. In order for the yield/cost of a GPM to be comparable to that of a FPM, it is obvious that the GPM payments will start below the FPM payment during the initial years and eventually rise above FPM payments. The benefit of a GPM is that it provides a better match between the homebuyer's expected income and mortgage payments. This is because household earnings generally increase with time (due to experience and job seniority). Therefore, a homebuyer would rather have smaller payments during the initial years and larger payments in later years. A related advantage of a GPM is that it enables more households to qualify for a mortgage. A key criterion in mortgage underwriting is not to have the payment-to-income ratio (ratio of the applicant's monthly mortgage payment to his/her monthly income) to exceed a certain level. Clearly, it will be easier for an applicant, especially a

young applicant, to satisfy this criteria under a GPM than a FPM.

As indicated earlier, a major challenge for an interest-free financial institution will be on the supply side of the funds. It is imperative for the long term success of interest-free mortgages to establish a secondary mortgage market and securitize the interest-free mortgages. One possibility to consider is to establish interest-free REITs (Real Estate Investment Trusts) by pooling interest-free mortgages and sell the shares of these REITs to the public. If designed according to certain set of regulations, REITs also enjoy special tax benefits.

A final point to mention is the refinancing option under the traditional FRMs. This option is very valuable to borrowers (and a concern for the lenders) because it allows borrowers to reduce their mortgage interest rates when the market interest rates fall. It will be difficult for homebuyers to enjoy such a refinancing option under an interest-free mortgage. The difficulty is related to two factors: one is that rents usually do not fall, and the other is that homebuyers will not have many, if any, alternative interest-free mortgage banks from which they can obtain the new mortgage with more favorable terms. On the other hand, an interest- free mortgagee would be able to offer lower payments to homebuyers as a result of avoiding the refinancing risk.

It may be worth to conduct a study to extract the preferences of potential customers in the U.S. for an interest-free mortgage. How much do they value tax benefits / losses? Do they view a home more like an investment good or a consumption good? What kind of features, such as the duration, evolution of ownership through time, rent versus appreciation sharing, etc. would they like to see in an interest-free mortgage? Such information can be obtained either through carefully conducted surveys or through laboratory experiments.

Concluding Remarks

The focus of this paper has been on the tax and incentive implications of an interest-free mortgage. The paper has emphasized the point of making an interest-free mortgage financially competitive to other alternatives in the market and providing the right incentives for the homeowners to expand the optimal maintenance for the property. Some Muslim economists may argue that such problems are not applicable because incentive problems would not exist in an Islamic economic environment. They take it as given that, due to the religious norms, Muslims would never choose an interest-based mortgage and the religion would act as a mechanism to eliminate any inefficiencies that arise out of incentive problems. However, if norms alone could be

sufficient to generate the desired outcome, then there would be no need for having any contracts for any transactions between Muslims or for an Islamic criminal law. Qur'an and Sunnah recognize that incentives play a crucial role in our behavior and establish the incentives/penalties to encourage/discourage certain types of behavior.

The role of incentives for the success of interest-free mortgages has been reported in a recent survey (Kazarian, 1993). A survey of depositors in Egypt's Islamic banks reveal that the majority of them had previously deposited funds in the traditional banks. Although the reason they gave for deposing their funds in an Islamic bank was the bank's contribution to the welfare of Muslims, many of them transferred their funds to traditional banks when the Islamic bank's rate of return fell below the prevailing interest rate in the market.

The critical role of incentives have also extensively been established in economics experiments. As I indicated in a recent article (Yavas, 1998), subjects in these experiments are not as cooperative and norm-oriented as the *homo sociologicus or homo Islamicus*. However, they are not as self-interest oriented as the *homo economicus* either. Experimental results show that both norms and incentives are important determinants of human behavior. Therefore, any interest-free mortgage must strive to be competitive and financially attractive to potential homebuyers.

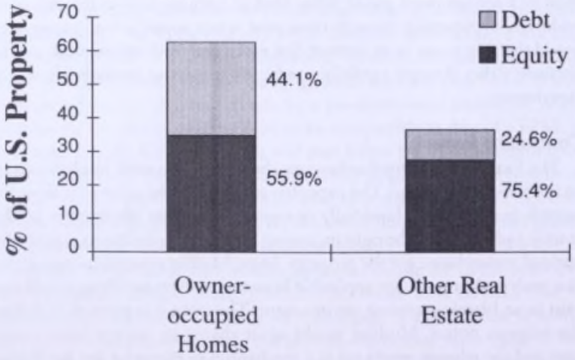

Figure 1

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Scope of Asset Securitization in Islamic Banking

By:
*Zamir Iqbal**

Efforts to establish a fully functional Islamic Banking System in post-world-war era started in 1930s but it was not till the 1980s that the growth accelerated as a result of the accumulations of oil revenues. The global wave to adopt a market-based economic system, privatization and capital market liberalization have further encouraged the development of Islamic financial system.[1] Despite considerable growth in Islamic financial market, its size is still far below its true potential mainly due to limited set of traditional instruments and the absence of financial innovation, Today's market is exhibiting a great demand for innovate instruments to enhance market liquidity achieve risk diversification opportunities and develop secondary market with the objective to attract a wider range of investors.[2] One of the most significant innovations in the West is asset securitization which has clearly contributed to the rapid development and the growth of financial markets domestically and internationally. Similar prescription for the Islamic finan-

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1. While the abolition of interest-based transactions is a central tenet of an Islamic financial system, it is by no means an adequate description of the system as a whole. Muslims' holy book, The Quran, explicitly states the prohibition of payment and receipts of interest (Ribā). All schools of thought agree that Ribā is not simply usury as often perceived by some. There is now a consensus of opinion that this prohibition extends to any and all forms of interest including excessive interest and the indexing of capital.

2. Hossein Askari and Zamir Iqbal, 'Opportunities in Emerging Islamic Financial Market,' *Banco Nazonaile De Lavaro Quarterly Review*, September 1995.

cial markets can help in achieving long tenn sustainable growth, attain market efficiency and more importantly, develop a greater integration of Islamic financial markets with other markets.

The 1980s witnessed rapid introduction of financial innovations in international financial markets. Financial innovations transformed the traditional financial and banking markets into a highly sophisticated markets featuring high degree of liquidity through enhanced marketability, negotiability and transferability of assets and liabilities. Both market forces—in financial markets and in the global economy generally—and government actions—macro-economic policies and financial deregulations—played a role. Bank for International Settlement (BIS) identifies three types of financial innovation activities with the most significant impact on the markets—innovations to enhance liquidity, to transfer risk (price and credit) and to generate revenues (from credit and equity).[3] The trend is occurred in both domestic as well as in international financial markets. As a result. financial development and innovations exhibited a positive impact on the growth and the expansion of real sector, thus contributing to the economic growth. Studies have demonstrated that the biggest difference between rich and poor countries is the efficiency with which they have used their resources; and a well developed financial system's contribution to growth precisely lies in its ability to increase efficiency.[4]

No doubt that the size of Islamic financial markets is growing but it is plagued by the absence of depth and breadth in the market—characteristics of a market with limited instruments. Since Islam encourages trade and entrepreneurship, the market is dominated by the financial instruments more suitable for trade and partnership. Currently the market is dominated by a number of traditional trade-related transactions featuring trade with mark-up or cost-plus financing (*Murabahah*) and lease agreements (*Ijara*). These constitute approximately 85-90 percent of all transactions while the rest are equity related transactions.[5] Demand for medium-term financing is met by profit-sharing agreements (*Mudarabah*) and equity partnership (*Musharika*) instruments. Although both profit-sharing and equity participation are also used for long-term financing, there is no specific instrument

3. Bank for International Settlement, *Recent Innovations in International Banking*, (Basle: Bank for International Sefflement (BIS), April 1986), pp. 130-139.

4. Philippe Jorion and Marcos Da Silva, *The Importance of Derivative Securities Market to Modern Finance*, (Chicago: Catalyst Institute, 1995), p. 5.

5. International Herald Tribune, 'Islamic Banking: World of Finance Reacts to Major New Resource,' (April 22, 1994), p. 9.

for long-term funding. At this time, medium-and long-term instruments hold a minor share of the market but their share is rapidly increasing as market exhibits strong demand for medium- to long-term maturity structure.

Further growth of Islamic financial markets will largely depend upon the development of the secondary market and introduction of innovative products. The development of the secondary market is essential to create and enhance market liquidity. Liquidity should be taken in a broad sense. encompassing not just money-like deposit instruments but the marketability and transferability of claims generally.[6] A market featuring liquidity facilitates the participation by investors seeking flexible maturity structure and lower transactions costs. Investors prefer liquidity to expand portfolios across capital markets and to achieve portfolio diversification. Financial institutions get access to whole new array of tools for asset/liability management. The lack of liquidity in the Islamic financial markets has indirectly limited the range of maturity structures available to the investor—Islamic investors are generally unwilling to participate in the long-term, contracts and they cannot readily liquidate their assets if they are in need of financial resources. In short, marketability, negotiability and transferability of financial claims create liquidity—an important dimension of the capital markets—by expanding the menu of options available to the market participants.

Development of secondary market and liquidity enhancement require financial innovations and re-engineering the characteristics of financial claims to liquidify the dormant financial assets. The process of innovation can be viewed as a process of 'unbundling and repackaging' different components of a financial instrument, e.g. return, price risk, credit risk, country risk. pricing conventions, duration, etc.[7] The repackaged financial assets cater to a different market segment which is willing to accept the repackaged deal to suit its financial goals and exposures. In its simplest form, it may involve isolating periodic income cash flow of an asset and selling them for better return. The notion of collateralized cash flows is very much compatible with Islamic financial system's principle to deal in underlying assets and resources allocated to the productive economic activities. Since cash flows are collateralized against an existing asset whose performance is known and is of deterministic nature, Islamic investors prefer such securities over others.

6. Bank for International Settlement, pp. 171-179.

7. Ibid, p. 169.

Formally, the term 'Securitization' is often referred to the process of enhancing marketability, negotiability and liquidity of an otherwise dormant asset. It allows hitherto relatively illiquid securities to be transformed into risk-diversified, high return vehicles for intermediating funds.[8] It involves packaging a pool of homogeneous assets that are normally not traded into tradable securities. This has been done either by using the original assets as collateral for a new tradable security; that is issued (collateralized obligation) or by issuing a new tradable security that is being serviced by the proceeds of the original asset (pass-through security).[9] The most prevalent forms of successful securitization in Western financial markets are securities backed by mortgages. car loans. leases, and receivable from inventory, credit cards and service centers like health care providers.

The securitization process involves five primary parties: the originator, the purchaser (typically an affiliated trust), the structurer or the underwriter, the guarantor and the servicer. The originator benefits by getting the asset off the balance sheet while other parties earn fee income for their respective role. The originator is the original owner of the financial asset who desires to liquidify the asset by taking the asset off the balance sheet. Purchaser of the asset is normally established by the structurer in the form of a Special Purpose Vehicle (SPY) to serve as a trust. The asset side of the SPY's balance sheet reflects the securitized asset and the liabilities side contain the certificates or notes issued against such assets. Special Purpose Vehicle (SPY) is setup in the form of a trust or in any other form which may be suitable considering the tax and accounting application of the deal. Guarantor plays the role of the credit enhancer to stamp the certificates with the investment grade credit rating. Finally, the function of servicing of the asset—often kept to itself by the originator—is performed for a per-determined fee. Figure I depicts the setup of a typical secuntization process.

8. Sylvester Johnson and Amelia A. Murphy, 'Going Off the Balance Sheet,' Federal Reserve Bank of Atlanta Economic Review, September/October 1987, p. 30.

9. International Monetary Fund, International Capital Markets: Developmentsj Prospects, and Policy Issues, (Washington, DC: International Monetary Fund, 1988). p. 36.

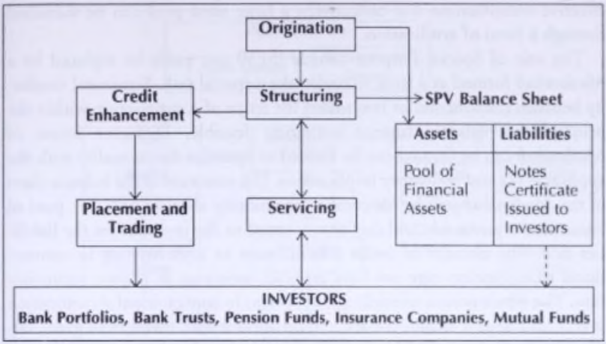

Figure 1. Securitization Process

Source: Askari, Hossein and Iqbal, Zamir, 'Liquidity Enhancement in Islamic Banking through Securitization,' Proceedings of Conference on Equity Funds, (London: AIC Conferences), Sept. 30-Oct. 1, 1996.

Issuers of the securities may benefit through improved capital-asset ratio, early recognition of expected gains or loss, or in case of high growth institution, capitalizing on opportunities yielding higher returns. From the investors point of view, securitization provide small banks, thrifts, and institutional investors such as pension funds access to the markets out of their own geographic and industry areas and enhances their opportunities to diversify their portfolios and to earn a higher rate of return for the asset in the same risk class. Even after deducting the associated transaction costs, the buyer of asset-backed securities tends to earn a risk-adjusted return superior to that available through other instruments with the additional protection of the collateralization of the securities; and it should be emphasized that in the process an illiquid asset has been made liquid.

Let's examine the mapping of the securitization process within the framework of Islamic finance. Leasing is a good candidate for Islamic securitization because first, it is a well established and recognized Islamic instrument and, second, it provides a collateralized and steady stream of cash flows—a desired feature for successful securitization. For the organization phase, Islamic financial institutions who wish to securitize can collect homogenous lease contracts, i.e. auto or equipment leases with similar maturities into a pool. Individually, institutions may not hold assets which can permit cost

effective securitization but collectively, a large sized pool can be launched through a form of syndication.

The role of Special Purpose Vehicle (SPV) can easily be replaced by a *Mudarabah* formed as a trust to undertake a special task. Structural similarity between the function of two makes the scope of securitization within the principles of Islamic finance extremely feasible. Different forms of *Mudarabah* can be formed can be formed to optimize functionality with the applicable tax and regulatory implications. The structure of the balance sheet of the *Mudarabah* will be identical to the balance sheet of SPV, i.e. pool of leases on the assets side and certificates issued to the investors on the liabilities side. The element of credit enhancement or underwriting in conventional securitization may not have an exact substitute in Islamic securitization. The whole notion of credit enhancement in conventional securitication is very critical as it stamps the secured certificates with investment grade rating. Similar function in Islamic finance can be emulated through an instrument based on the principle of Islamic suretyship (*kifala*) or insurance (*Takaful*).

Kifala relating to a financial claims implies an obligation to pay in the event of the principal debtor's inability to honour his obligation.[10] *Takaful*, Islamic insurance, can provide the function of credit enhancement by establishing a fund to cover future losses or inability to perform. This fund can be financed by a fee charged as part of servicing the asset and any surplus or residual after deducting costs can be distributed back to the subscribers as the maturity approaches. The remaining functions of placement, trading and servicing can be replicated in Islamic finance without requiring any special instrument. Based on the analysis in the proceeding section, it is clear that securitization of assets can be implemented in Islamic finance. Typical applications of assets securitization can be in the area of leasing, commodities, equities and trade and export receivables. Ijara (lease) instrument qualifies for the securitization because of its distinct feature of generating collateralized and pre-determined cash flows.[11] Figure 2 illustrates the structure of lease securitization within the framework of Islamic finance.

10. Hasanuzzaman, S. M., 'Islamic Law and Finance,' Encyclopaedia of Islamic Banking and Insurance, London, 1995, p. 82.

11. Askari, Hossein and Iqbal, Zamir, 'Liquidity Enhancement in Islamic Banking through Securitization,' *Proceedings of Conference on Equity Funds*, (London: AIC Conferences), Sept 30-Oct. 1, 1996.10. Hasanuzzaman, S. M., 'Islamic Law and Finance,' *Encyclopaedia of Islamic Banking and Insurance*, London, 1995, p. 82

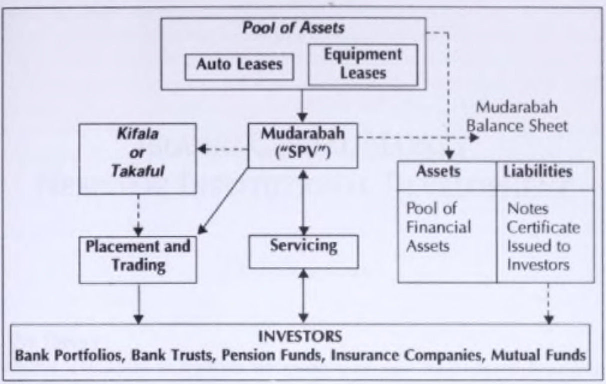

Figure 2. Islamic Funds—Application of Securitization

In conclusion, the survival and further development of Islamic financial markets largely depend on the nature of financial innovations introduced by the market players. Long-term sustainable growth can only be achieved by developing a well functioning secondary market and introducing liquidity enhancing products. Securitization will help development of secondary market and introduction of negotiable and marketable financial instruments. Availability of marketable and liquidity enhancing instruments will expand opportunities for the Islamic investors and will facilitate the use of a wider range of instruments for a wider range of purposes. This greater choice will enable investors to achieve portfolio diversification and to equip themselves with asset/liability management capabilities. Liquidity in the market wil also enhance interlinkages of markets and will work to increase the efficiency of financial markets.

Islamic Capital Market
Need for Institutional Development

By:
M. Fahim Khan[1]

The Theory

Islamic principles of finance recognize only two methods of financing whether by individual or by an institution. These are:

1. Providing a loan
2. Making an Investment

When the financing is in the form of a loan, there is no return on capital but the repayment of capital is guaranteed. When financing is in the form of investment, capital may earn return but only after subjecting itself to the risk of loss.Capital cannot be absolved of the risk of loss if it expects a return from the investment. Hence, there can be no ex-ante guarantee about the amount or rate of return on capital.

In Islamic framework, there are following direct modes of investment financing:

1. Equity financing so that financing becomes a permanent part of the equity capital of the enterprise.
2. Profit Loss Sharing (PLS) financing which is essentially in the nature of equity financing, except that it may not be a permanent equity in the enterprise, and may only be contracted for some specific period or for some specific activity of the enterprise.

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In both cases the financing will share the outcome of the enterprise (profit or loss) in proportion of its share in the total capital of the enterprise. It is, however, possible that finance provider may accept a share in profit different from the proportion of its financing in the total capital. But it is essential that in case of loss, the loss is shared in exact proportion of the share in the capital[2].

It is possible that the financing may form 100 percent of the capital in the enterprise. (That would be termed as a Mudharaba contract). In that case, the financing may share the profit from the enterprise in any ratio agreed in the contract, but in case of loss, the entire loss will be paid from the capital.

Besides, these direct modes of financing there are several other contracts permissible under Shariah, that can be used as indirect modes of financing. These include:

1. Trade based mode of financing. In this case, the financing is built-in within a trade contract. The finance provider, may purchase the goods needed by the enterprise and resell them to the enterprise with his own profit margin (called Markup) and may agree to receive the payment of the price at some date in future. The price may be paid in installments as well, if agreed upon in the contract.
2. Leasing based finance. In this case, the financing is implicit in the lease contract. The finance provider may purchase equipment or an asset and lease it to the enterprise. If the enterprise is interested in owning the equipment or asset, it may pay an agreed upan price in lump sum or in installment. As it pays the price, the rent will be reduced in proportion of the payment of price made by the enterprise.
3. Salam Based financing. In this contract too, the financing is an integral part of the sale contract. The purchaser makes an advance payment in lump sum to the producer of a commodity (generally agriculture commodity or a commodity that is normally available in the market) who agrees to deliver him the commodity at some specified date in future.
4. Ististana based contract. This is a contract to manufacture or build something according to the defined specifications to be delivered at

2. For example, financing may be made in an enterprise that has earned some goodwill and/or has some human capital invested in the enterprise along with the physical capital. It is logical that finance provider may be offered a share of finance in the nominal capital in the enterprise. There is however no exception in Islamic law for sharing of loss. It has to be in exact proportion of the share in the nominal capital.

some specified future date. The purchaser may finance the project either by making all the payment in advance to the manufacturer or contractor or may pay it in installments on different stages of completion of the contract as may be mutually agreed upon.

This is a brief picture of various contracts that can be utilized in the financial dealings in an Islamic system.

The theory of Islamic economics and finance believes that the banking system of Islam should be based on the direct modes of finance i.e. on the basis of Qardh Hasan and PLS. There is now plenty of literature available, contributed by Islamic scholars as well as conventional economists to highlight the advantages of this system over other financial system particularly the interest-based system.

I will briefly enumerate here some of the benefits of the Islamic financial system.

From Entrepreneurs' (Finance Receive's) Point of View

Since the finance provider is not asking for a guaranteed repayment of capital and a fixed return irrespective of whether the business makes a profit or loss, the entrepreneur feels more comfortable with this financing. The risk bearing capital of course is a help to entrepreneur particularly in starting a new business.

From Finance Providers' Point of View

Though the finance providers will have to be more careful and will have to make extra effort in selecting the business to invest in, yet this will go to his/her advantage.

Since he/she is sharing the profit of the enterprise, the expected incomes will be more than what he would earn under interest based lending.

From the Banking System Point of View

Since the banks will share the profits of their clients on the assets side, they can pay their depositors (on the liability side) on the same basis. The profit sharing ratios can be fixed in a way that they leave a profit margin for themselves (banks) also. The banks therefore can still play the role of financial intermediary, and hence continue doing the useful service to the society of minimizing information and transaction cost of pooling the savings and advancing them to the potential investors.

According to economic theory, the banking system based on PLS system has to be more efficient than the interest-based system. Efficiency means that

capital should be made to flow where it is more productive. Since the banks operating under PLS will be sharing the profits, they will therefore be looking for projects or enterprises where there is more profit. Under interest-based system there is no such built-in compulsion on banks. Since their capital and a predetermined return on it will always be secured and guaranteed, their primary concern is credit worthiness of the client rather than the profitability of the project or enterprise where the funds are being invested. Hence under interest-based system the capital may not be as efficiently allocated as under PLS system.

The banking system based on PLS is believed to be more stable too. Since the banks are sharing in profits as well as losses, it will be in the interest of the banks to diversify their investments. This compulsion is not present in the interest-based system. It is cost effective for the banks (looking for credit worthiness of the clients) to depend on as fewer clients as possible. But this makes them vulnerable to insolvency of even one or two clients, if they have significant portion in the total investments of the bank. This is because the liabilities of the banks are fixed. Any shocks on assets side would create imbalance in bank's assets and liabilities. This may send a wrong signal to the depositors. There may be a run on the bank. The depositors reaching the bank first may get their money back those reaching late may not get anything at all. The banks can collapse quickly[3]. This may not happen under PLS. Any reduction in liability will immediately get translated into a proportional reduction in the deposits/liabilities. The run on the bank will be of no use. Waiting may help as bank may recover the loss over time.

From the Economy Point of View

The chances of hitting a financial crisis will be lower in an economy that has a PLS based banking than the economy that has an interest based banking system. First of all the interest rate effect is absent. If factors, like exogenous increases in demand for credit or reduction in money supply, increase the pressure on bank funds, the bank, operating under PLS-principle, will only have more choice of projects to select from. The chances of adverse selection will decline and the profits of the bank will increase, as it will be selecting more profitable projects. The higher profits of the bank will trickle down to depositors in terms of more return on their deposits. The demand for lending will increase. This is an affect opposite to whet may happen if oxogenous demand for credit increases in an interest based banking system.

3. For more discussion on this, see Mohsin Khan, "Islamic banking: A Theoretical Analysis" in Mohsin Khan and Abbas Mirakhor (Eds.) Theoretical Studies in Islamic Banking and Finance, the Institute for Research in Islamic Studies, Houston, Texas, USA, 1987.

The increase in credit demand for example may lead to an increase in interest rate which pushes the good credit borrowers back and hence enhancing the chances of adverse selection for the bank leading to reduced lending and reduced aggregate activity in the economy. Furthermore chances of bank runs are lesser in PLS-based system than in interest based system. If a bank gets into a trouble, it is in the interest of the depositors to run to get their deposits. In a PLS based system the run will not be in the interest of the depositors. They may gain by waiting. This element of relatively more stability and non-vulnerability of the financial intermediaries to sudden or unanticipated shocks also makes the economy less vulnerable to financial crises.

From the Society's Point of View

As already mentioned, interest based system finds it cost effective to concentrate its investments on its assets side on a few major clients whose creditworthiness provides the security of the investment and guarantee of a fixed return on it. The banking system thus collects small savings from a large number of savers and passes them on to a fewer (but rather more affluent) members of the society. The system thus is geared towards promoting income and wealth inequalities in the society. On the other hand, PLS system is compelled to spread its investment as much as possible (in order to minimize risk of possible losses). This spreading coupled with the search of more profitable projects (rather than creditworthy clients) is likely to gear banks' investment to relatively smaller enterprises.

Furthermore since banks are offering risk bearing capital for investment, this may motivate new entrepreneurs to enter the market who were otherwise outside the entrepreneurs market because:

1. They lacked sufficient collateral to offer to attract banks investment (despite having a commercially feasible project).
2. They lacked the capacity to bear the risk of loss on top of guaranteeing the repayment of capital with a fixed predetermined interest on it.

The system would help part of the human resources to convert themselves into entrepreneurs rather than sit idle or work for a fixed wage.

The Practice

With such features, it is curious why this (PLS based system) could not come into practice. There are more than 100 Islamic banks reported to be

operating in various parts of the world. All of them preferred to work on the basis of indirect modes of financing rather than using PLS basis for most of their investment operations. There are a couple of countries that tried to implement the Islamic banking system through out the economy. They too relied heavily on the indirect Islamic modes of financing instead of direct modes of financing.

Economists have tried to answer the question that why a banking system based on Islamic principles of finance in general and PLS principle in particular could not come into wide practice despite its convincing superiority over interest based system, in theory. The most frequently advanced argument is that it is a costly option in a market with imperfect information. In the presence of imperfect information, the entrepreneur has more information about the project than the finance provider does (a problem often referred to as problem of "Asymmetry of Information". In the presence of asymmetry of information, first there will be cost in avoiding adverse selection of enterprise for investment and then there will be cost to monitor that the investment is not misused and that the risk of moral hazard[4] is minimized. A fixed return debt option secured by collateral is therefore less costly option compared to investment option based on Islamic financial principle in general and PLS principle in particular[5]. The risks of adverse choice in selection of projects and monitoring costs or incentive package to reduce moral hazards are claimed to be the main reason for the absence of PLS based contracts.

This argument is however far from providing sufficient grounds to justify absence of PLS based financial system from the market. The problem of asymmetry of information and hence the consequences of adverse selection and moral hazard are present in the interest based debt financing also. But the institutions developed in the society to take care of the problem. They minimized the costs resulting from asymmetry of information. These institutions are now known as "banks". Hence the question still remains. Why institutions did not to promote the PLS-based financing which is, in theory, is superior to interest based financing.

No doubt the PLS-based system has the issue of the asymmetry of information. The issue is not unique with the Islamic financial system. The interest-based system is still facing this problem despite the fact that the system

4. Moral Hazard is a term used to refer to a situation where agent (entrepreneur in our case) will engage in activities that will be against the interest of the principle (finance provider in our case).

5. For detailed discussion on this see, Abbas Mirakhor, "Progress and Challenges in Islamic Banking", *Review Of Islamic Economics*, Vol. 4, No. 2, 197, pp. 1-11.

minimizes the need for information by demanding collateral and guarantees. To help the interest based financial institutions to reduce the problem of adverse selection (caused by asymmetry of information at the time of making decision for investment), the institutions have been developed to provide and process information to distinguish bad firms from good firms. To reduce the problem of moral hazards (problem after the investment has been made), a lot of research has been made on how to build a suitable incentive package within the contract that the enterprise does not use the finance in a way that is counterproductive for the finance provider. Presley and Session have shown that efficient contracts, to induce agents to deliver in accordance with the contract, are possible with Islamic methods[6]. It has also been demonstrated that interest based financing has its own costs to minimize inefficient default which may not necessarily be lower than the cost of making the PLS contracts with sufficient incentive compatible to induce the agent (finance user) to deliver according to the terms of contract. The imperfect information, thus, makes interest based financing also to suffer from the risks of adverse selection and moral hazard[7] and hence is not a problem unique to the Islamic (PLS/Equity based) finance.

When we are talking about economies like USA and when we consider corpoate sectors in such economies, the argument relating to imperfect information do not carry much weight. There have to be reasons other than imperfect information, which are keeping the principle of PLS-based financing away from the banking and investment sectors even from such economies as USA.

Another set of arguments explaining the absence of superior alternative from the market is in terms of the often-observed law of "bad commodity driving good commodity out of circulation"[8]. The establishment of a superior alternative like PLS system may require a complete abolition of the already existing inferior alternative. The Quran has referred to complete eradication (annihilation) of interest. The words YAMHAQ has been used in verse 2:276 to convey this sense. The contemporary practive of Islamic finance, however, is forced to coexist within the interest-dominated environment. Such coexistence has several implications for the practice of Islamic finance, constraining it severely to move in the directions compatible with Islamic philosophy and ideals in the field of economics and finance. The

6. J. R. Presley and J.G. Sessions, "Islamic Economics: The Emergence of a New Paradigm", The Economic Journal, Vol. 104, No. 424, May 1994.

7. See Abbas Mirakhor Op. Cit.

8. M. Fahim Khan, Essays in Islamic Economics, Islamic Foundation, Leicester, UK, 1995.

problem, in operating an Islamic concept within a non-Islamic framework, is that it has to use the institutional framewrok that has not been designed for its aplication. Institutions designed to promote a totally different concept and philosophy will always leave Islamic options as disadvantage in the market. Development of Islamic capital markets requires its own institutional infrastructure. Product innovation to suit the needs of the agents in the market will not go far enough without a simultaneous development of appropriate infrastructure. As a Harvard professor puts it, "The imbalance between product innovation and infrastructure could at times become great enough to jeopardize the functioning of the system"[9].

Some Institutional Needs

This paper identifies some institutional needs, with particular reference to US capital market, that are required to be met in order to promote the application of the philosophy of Islamic finance. It is believed that such effort in institutional development will trigger a snow balling effect for the application of Islamic financial principles not only in the US economy but also in other parts of the world. It is curious to note that London is now widely known to be the center of international Islamic capital market while US capital markets seem not to pay as much attention to this growing phenomenon. America may not lag behind for long. This paper hopes to provide some directions for the type of efforts needed to make the break through.

Problem of Information Cost and Adverse Selection

Why the PLS-based financial institutions could not come into existence so far in the US capital market? Let us take the popular argument relating to the "asymmetry of information" between the finance user, which is believed to be a major hurdle in the application of PLS/equity-based modes of financing. Akerlof's article on Market of Lemons can help us understand this issue more easily[10].

Lemon refers to a used car that is going to continuously give problems to the owner. In the market of used cars it is often not possible to distinguish a lemon from a peach (a good car). The price of a used car in the market will be somewhere in between the value of a lemon and a value of a good car. The

9. Robert Merton, "Financial Innovation and Economic Performance", Journal of Applied Corporate Finance, Winter 1991.

10. George Akerlof, "The market for 'Lemons': Quality, Uncertainty and Market Mechanism", *Quarterly Journal of Economics*, No. 84, 1970, pp. 488-500. (For the application of this to investment in corporate sector, see Stewart Myers and N.S. Majluf, "Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have", *Jour-*

seller of the car knows whether his car is lemon or peach but the buyer does not know it. The seller of the lemon of course will be willing to sell his car at the market price (which is between the value of a lemon and a peach). The owner of peach will not be willing to sell it in the market because the market price is less than the value of his car. Since the buyer is also aware of this fact, (that lemon owner will be more than keen to sell their car than the peach owner will), there will be fewer sales in the market.

In this scenario, let us replace "market of used cars" by the "market for PLS/equity based financing, replace "the used cars" by projects of the firms seeking PLS-based finance in the market. Replace the "buyers" by the investors, banks or financiers. The conclusion will be that there will be fewer (if any) projects financed and there will be no effective market for the projects for financing on PLS basis.

If this is the only issue in the application of the PLS-based finance, then Islamic banks and financial institutions, should not find much problem in the application of PLS based financing if they confine themselves to the corporate sector in USA. There is enough legal and institutional provisions for the US corporate sector regarding disclosure of information that asymmetry of information may not be a binding constraint in the application of the PLS based modes of financing. Companies like Standard and Poor, Moody, and Value Line, publish enough data to help distinguishing bad firms from good firms for the purpose of investment.

For US capital market (particularly in the context of corporate sector), it is probably not the problem of asymmetry of information. There may be some other issues involved. One obvious issue is the taxation of corporate income. In the presence of income taxation, it is not in the advantage of corporation to mobilize capital on the basis of equity. The answer to the question whether Islamic financial institutions will be able to invest in the US corporate sector on the basis of Islamic principles will have to be looked for beyond the issue of information asymmetry. (The question to be further discussed in the next section.)

The problem of asymmetry of information however may be valid for Muslim businessmen in USA outside the corporate sector or for the Muslim corporations not rated by the rating institutions. How Islamic firms or entrepreneurs can attract PLS/equity based capital? There may not be shortage of potential Muslim investors who can meet their capital need. There may be Muslim investors who may not like to invest in equity of the conventional corporations. Bulk of these corporations utilizes interest-based borrowing. There is a ruling from the OIC Fiqh Academy that it is not permissible to invest in such companies.) These investors willing to invest with the Islamic

entrepreneurs/firms on PLS/equity basis. Thus there may demand as well as supply for PLS-based financing. If there are not coming together then it may be phenomenon similar to the phenomenon described above as "Market for lemons". This raises the need for institutions that can help minimizing the information cost of matching the Islamic investors with the good firms willing to get finance on Islamic basis. The conventional bank-type structure may not do this job. Some other structure may be needed to reduce information cost for avoiding the problems of adverse selection and moral hazard.

Need for developing fixed income Securities within PLS Framework

The firms that opt to operate according to the Islamic principles face serious dilemma in operating in the conventional capital markets where they cannot benefit from the use of the interest based fixed income securities. A couple of reasons for this are discussed below.

Firstly, in the presence of income tax, it is always beneficial for the firms to raise capital through borrowing on interest than to raise capital through equity. The more a firm borrows the more profitable it becomes. (The famous M&M Proposition No. 1)[11]. If there is no fear of bankruptcy or risk of getting the firm acquired by the creditors, the firm will like to have all its capital in the form of funds borrowed on interest. If an Islamic firm does not mobilise funds through interest based bonds etc.; it stays at disadvantaged position compared to the firms that can do so. The Islamic firm will be forced to operate with a sub-optimal capital structure in the conventional capital market. If the Islamic firm is operating in recession, so that it has a rate of return on equity less than the rate of interest on bonds, there will not be as much supply of capital as will be for the firm that can raise capital through interest based bonds. If the firm is operating in high profit conditions, cost of equity capital for it will be high and it will be at disadvantage in raising capital from the market compared to the other firms. The competitive operation of an Islamic firm within the conventional market requires Islamic firms to have an ability to benefit from fixed income securities, bonds etc.

Secondly, the inability to utilize fixed income securities, not only limits the leverage capabilities of an Islamic firm (and hence limiting their abilities for capital budgeting and financial management) but also puts the Islamic firm at disadvantaged position with respect to the hedging and risk management. Having the choice of utilizing Shariah based fixed income securities, Islam-

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11. F. Modigliani and M. H. Miller, The Cost of Capital, Corporate Finance and Theory of Investment", American Economic Review 48, June 58, pp. 261-97.

_______________, "Corporation Income Taxes and the Cost of Capital: A Correction", American Economic Review 53, June 1963.

ic firm will have the ability to get some of their financial risks hedged and hence putting themselves at equal footings with the firms that are using interest based instruments as tools for hedging.

Thirdly, Small savers often are not inclined to take risk. They would like to have low but known return on their savings rather than to expecting higher returns by subjecting their savings to substantial risk bearing. Also there are always vulnerable groups in the society/community that cannot afford taking the risk of loss at all with their savings. They either would invest in fixed income guaranteed opportunities or would keep them without earning any return on it (if expecting return means bearing the risk of loss also).

In the contemporary thought on Islamic finance, the concept of fixed income securities has not found any place so far. Though some efforts have been made to define Islamic bonds and certificates carrying fixed rate of income, these efforts do not have general approval from the Sharita scholars[12]. For majority of the Shariah scholars, the concept of fixed income Securities, without violating or bypassing Shariah rules, is still unthinkable.

The discussion below highlights the types of Islamic fixed income securities that can possibly be developed and the type of institutional support that will be needed to bring them in operation. The discussion has been made in the background of the role that conventional institutions have played to bring the interest based fixed income securities in operation.

Fixed income Securities

To start with, let me quote the following precedence from the conventional capital market.

"A railway company orders some cars and locomotives from a manufacturer. When the job is finished, the manufacturer transfers legal title of the equipment to a trustee. The trustee leases it to the railroad that ordered it and at the same time sells equipment trust certificates (ETC) in an amount equal to large percentage of the price, normally 80 percent. Money from the certificates is paid to the manufacturer. The Railway Company makes an initial payment of rent equal to the balance of the purchase price. The Trustee collects lease rental money periodically from the railroad and use it to pay interest and principle on the certificate. These interest payments are known as dividends. The amount of base rental payments is worked out carefully so that they are enough to pay the equipment certificates. At the end of some period

12. These efforts are based on the concept of purchase of loan and discount. This concept is generally unacceptable. Even where it is being used, it has a reluctant approval from the local scholars in order to overcome the contemporary difficulties in competing with the interest-based bonds and Securities.

of time, such as 15 years, the certificates are paid off. The trustee sells the equipment to the rail road for some nominal price and the lease is terminated"'[13].

This model can be tailored to develop an Islamic fixed income security. An Islamic Trust will lease the equipment to the company that ordered it and at the same time will issue Equipment Trust Certificates (ETC) to the general public to raise funds to pay for the price of the equipment to the manufacturer. ETC holders are made the primary owners of the equipment who can lease it to the Trust to claim a fixed periodic rent from the Trust. The Trust, in turn, will then lease the equipment to the company who ordered it. The difference in the rent contracted with the company and the rent promised to the ETC holders will be determine profit of the Trust. Alternatively, The ETC holders, primary owners of the equipment, can resell it to the Trust (instead of leasing it) and receive the price from the Trust in installments. The installments will be calculated in a way that tile ETC holders get back their capital as well as a fair return on their capital. The Trust, in turn can sell the equipment to the company that also promises to pay back the price in installments. The total price and the installments to be paid by the company will be determined in a way that the Trust is able to pay the installments promised to ETC holders and also earn a profit for itself. (A combination of leasing and installment sale is also possible).

ETC represents ownership of the holders of ETC in the equipment and therefore entitles them to earn lease amount in the form of fixed income.By virtue of being leasing based, fixed (rental) income to the ETC holders is guaranteed. Though there is a possibility that the trust may stop receiving rent if the machinery is damaged or loses its productive capacity for which it has been rented. However, since the trustee can always get the equipment appropriately insured[14], the guaranteed fixed income can be accordingly ensured. Despite getting the equipment insured there might still be risks. The railway company may still stop payment of rent despite the equipment as well as its working condition or usufruct is insured for its effective life as there may be problems not covered by the insurance or there may simply be a default on the part of the railway company. But these risks are manageable through appropriate institutional arrangements. It can be seen that their dividend on ETC is not contingent on solvency of the company for which equipment has been purchased. If the company becomes insolvent, the Trustees can take back the equipment and lease to someone else to continue the payment of

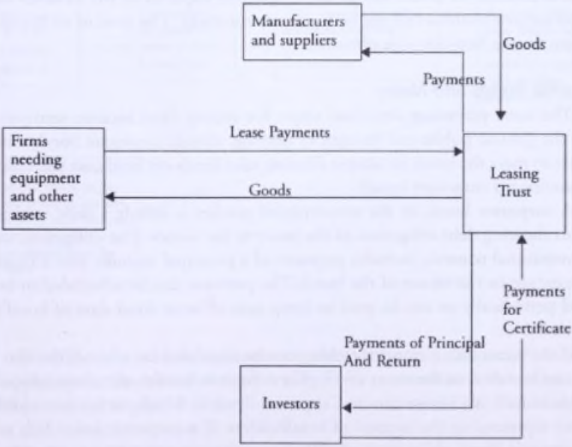
13. F. J. Fabozi and T. D. Fabozzi (Eds.), The Handbook of Fixed Income Securities, 4th Edition, Irvin Professional Publishing, Chicago, 1995, pp. 213.

14. For Shari'a permissibility of insurance see, Sheikh Mustafa Zarqa, *Al-Fiqh al-Islami fi Thowbihi Jadeed*; Damascus, Matabi'l Alif Ba al-Adib, 1967.

dividend on ETCs[15]. Otherwise the Trustee remains only an intermediary.

The question then remains why such an Islamic Trustee could not come into existence in the last three decades history of Islamic finance movement. Securitization is an expensive process. The size of the market, therefore may have been a binding constraint in the way of establishing a trust for a single asset trust. However' since the model mentioned above may not require substantial changes to make them Shariah compatible, the conventional trusts too can find it feasible to develop the certificates that are acceptable to Islamic investors also.

The conventional leasing trustees however deal in mortgage backed assets. To make them issue Securities based on Shariah-acceptable methods of leasing, some provisions may be required in the legal framework of the trustees. Conventional leasing trusts may not take initiative in this direction. This initiative will have to come from the clients of Islamic financial system. Alternatively, there is possibility of establishing a general purpose leasing trust that will lease different equipment to different firms[16]. A general purpose leasing trust can develop itself in to a pool serving the needs of different firms for different equipment and assets. The following diagram explains the model.



15. Fabozzi and Fabozzi pp. 213-216.

16. Frank E. Vogel and Samuel L. Hayes III, Islamic Law and Finance; Religion, Risk and Return, Kluwer Law International, The Hague, The Netherlands, 1998.

A combination of Istisna contract and Murabaha sale contract can also result into ensuring a fixed income for the financier. This is done in the following way.

There is a beneficiary B who needs capital goods to be produced by a manufacturer or some infrastructure to be constructed by a construction contractor C. Financial institution A agrees to finance the construction or the manufacture. The beneficiary B agrees to buy it from A at $1million later at a specified date in future when it is ensured to be made ready by the C. A finances the construction or manufacture by making scheduled payments to C (according to an Istisna contract) which will total $800, 000/-. A thus has a fixed income of $200,000 after all guarantees have been obtained with respect to the contractual obligations for deliveries and payments. (This is being practiced presently though at a very limited scale and is termed as back-to back Istisna). This fixed income can be made a basis of issuing fixed income securities. B issues the securities to public to participate in the profit that A would get from the project. The intermediary can guarantee the mount of profit on the securities because his profit from which he will share with the bondholders is guaranteed too. Bank, as a financial institution may find it difficult to undertake all the operations required in the issuance of fixed income securities on the basis of such contracts. The need of an appropriate trustee here too is as obvious.

Islamic Bonds and Notes

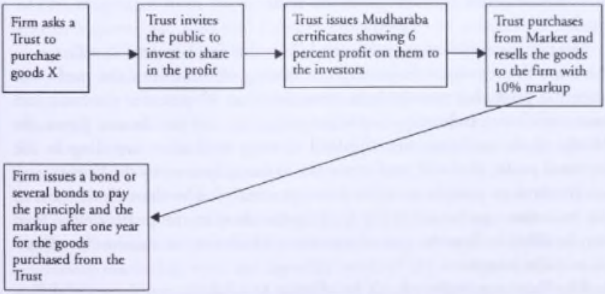
The same procedure described above for issuing fixed income securities for the general public can be used to develop Islamic corporate bonds and notes to meet the needs of Islamic firms to raise funds on fixed cost basis like conventional corporate bonds.

A corporate bond, in the conventional market is simply a debt instrument showing debt obligation of the issuer to the owner. The obligation, in conventional context, includes payment of a principal amount plus a fixed percentage to the owner of the bond. The payment can be scheduled to be paid periodically or can be paid in lump sum at some fixed date of bond's maturity.

If the issuer fails to meet the obligation as stipulated for a bond, the matter can be taken to the court and legally enforced. Besides, the conventional markets have an institution as Corporate Trustee, which serves as a third party representing the interest of bondholders. If a corporate issuer fails to pay its stipulated obligations, the Trustee may take such action as may be necessary to protect the rights of the bondholders. A corporate Trust can be a bank with a corporate Trust department to discharge the above mentioned

functions. The bond issuers pay the trustees.

In Islamic context, the concept of Murabaha (Markup) based sale contract involving deferred payment can provide a basis for issuing bonds and medium term notes (MTN). It is possible in a sale contract to charge a price higher then the current market if the payment is deferred. The markup can be fixed and predetermined in such a transaction. There is also no objection if the markup in the sales contracts varies positively with the period for which the payment has been deferred, (reflecting the time value of money)[17]. The seller thus can receive a bond or a note from the purchaser showing his obligation to pay to the seller the agreed upon sale price including a fixed predetermined markup for the deferred payment. Though markup is an implicit part of the sale price but it can be explicitly stated in the Bond or Note. The payment can be stipulated in installments also. Thus an Islamic firm can issue to another firm or individual from which it is purchasing goods or equipment a bond similar in form exactly to the one that the conventional market is familiar with. The following example may explain this.



Firm 'A' needs to mobilize funds to purchase certain machinery. Firm B is supplying the machinery at the price P* if the payment is to be made over 10 years (and at price P if the payment is made in cash). The P* of course

17. For a detailed discussion on time value of money in economic activities in Islamic framework and how it differs from interest on loans, see M. Fahim Khan, "Time Value of Money and Discounting in Islamic Perspective", Review of Islamic Economics, Vol. 1, No. (2), 1991, pp. 35-45.

has an implicit annual markup rate of m compensating for the deferred payment. For this transaction A can issue a bond showing an obligation to pay a payment P* which includes the principle amount (cash price of machinery) and a markup for deferred payment. If it is mutually agreed that the whole payment will be made at the end of 10 years with no payment in between, it is same as a zero coupon bond. It may also be specified with a payment schedule spread over the 10-year period in a way that it may look like a fixed rate (straight) bond of the conventional capital market, giving a fixed income over time.

This will serve the purpose of the Islamic firm. The Islamic firm will have the privilege and benefits of issuing bonds like any other conventional firm in the market.

The diagram shows that the trust issues fixed income Securities for the general public too which may seem curious at first sight. It will be instructive to note that there are two types of fixed income certificates that can be issued in this transaction:

1) Mudharaba certificates issued by the Trust to the public
2) Bonds issued by the Firm to the Trust

Mudharaba certificates in this model are also fixed income certificates in the sense that the bank in principle is sharing 40 percent of the profit but since the profit has already been determined as 10 percent, the bank can issue certificates indicating 6 percent return on the certificates. Since the Mudharabah certificates are supposed to share the loss or any drop in the expected profit, the bank may insure the in time payment by the firm or may ask the firm to provide an appropriate guarantees. The share in the cost of the insurance can be implicitly built in the share in the profit or the firm may be asked to bear the cost of insurance, which may or may not be adjusted in the markup.

The Trust may collect funds by offering Mudharaba certificates of different maturity (instead of single maturity equal to the maturity of the bond from the firm). The Trust will provide the small savers opportunity to match their investment with their liquidity needs. For example, some one may need to pay the house rent after six months, school fees after nine months and utility bills after 3 months. He can purchase certificates every month of required maturities that will not only allow him to pay his obligations but will also earn income for the period for which his savings were with the Trust. The banks, particularly Islamic banks, may also be their investors besides the general public. Their (banks') funds can be used to make-up the

deficiency in supply of funds of any particular maturity.

The Islamic bonds can be made on the basis of installment sale as well. The installment resulting from a sale will include two elements

1) Payment of the principle
2) Payment of the mark up

They can be defined in a way to make them competitive with other bonds in the conventional market.

The Islamic bonds can be made participatory bonds as well so that the bondholder shares the profits or income of the issuer (while the repayment of the principal is not contingent on level of earnings).

The Trust will have the capacity to generate not only the long term Islamic bonds but also the medium term notes (MTNs). " Few innovations in finance [in the conventional capital market] have been as successful as the medium term note. Its success derives from its remarkable adaptability to the needs of both the borrowers and investors."[18]. Medium Term Notes too are simple debt instruments but they differ from corporate bonds in terms of the flexibility they provide to meet the needs of the investors and finance user. MTNs originated from the need of financing the sale of cars/automobiles and to improve the asset and liability management of automobile finance companies. These companies needed financing to match the maturity of their own loans to the dealers and consumers. Underwriting costs and other complexities served as a restraint to issue corporate bonds because the financing was needed for relatively quite shorter period than usually meant for corporate bonds. The growth of MTNs initially remained limited because of the absence of the secondary markets for these notes. Later on investment banks entered the business of MTNs as agents and committed not only the resources for meeting the primary financing needs but also developed a secondary market (by standing ready to buyback MINs in the secondary market) to meet the liquidity needs of the holders of MTNs.

Islamic banks, which are essentially in the nature of investment banks,have lot of potential in helping the capital market developing such instruments on Islamic lines. The concept is simple and shares a lot of ground with the Islamic concept of markup based financing. Until Islamic banks come forward in this area the Corporate Trust mentioned above can issue these notes as well.

For issuing a conventional MTN, the issuer does not have to make the announcement in the market. The MTN can be issued to the investor by the

18. Fabozzi & Fabozzi, pp. 253.

issuer either directly or through the issuer. After establishing an MTN program, a borrower may enter the MTN market continuously or intermittently with large or relatively small offerings with different maturities and special features that are tailored to meet the needs of the issuer[19]. The possibility of continuous or intermittent offerings allows the issuer to manage the cost of financing. MTNs may not be initiated by the issuer only. Even investors may play an active role in the issuance process by a phenomenon known as reverse inquiry (an inquiry to determine if there would be someone seeking finance to match his desired maturity, size of offerings etc. Such possibilities benefit the issuer in getting the financing (borrowing) cost reduced and also benefit the investor to use his funds to his best advantage[20]. These features intrinsically have nothing to preclude the issuance of the Islamic MTNs on the basis of Murabaha sale contract.

Even Government securities can be issued in the form of Islamic MTNs particuarly for the international market (e.g. US capital market). Central Banks of Muslim countries can have special department or affiliated trust to operate on the basis as described above in the case of Islamic bonds. This may fulfill to a large extent the some Muslim government's needs to replace their interest-based securities with Islamic securities.

Secondary Market for the Islamic bonds, Notes and Securities

As long as ETC are leasing based they will represent title of ownership in a physical asset. Such ETC thus can be sold in the market. They will have their own secondary market providing the necessary liquidity to the ETC holders.

Islamic bonds and notes will be in the nature of debt and so will be the ETC if they are based on the concept of sale rather than on the basis of lease. All these debt-based instruments are in the nature of a monetary debt. It therefore cannot be sold in the market (at discount) before its maturity. That, of course, puts a limit on its usefulness as an effective instrument for the capital market. The secondary market however, may not be totally absent and there may still be ways for the holders of this bond to enjoy liquidity, if needed. The following needs to be considered in this respect.

Firstly, there will be no distinction from the conventional market point of view for a bond or note issued on markup sale based contract by an Islamic firm/trust or an interest based bond issued by a conventional trust/firm. For the purpose of Islamic firm, it does not matter whether it is issuing the bond to a Muslim or to a non-Muslim. Its financial needs are met.

19. Fabozzi & Fabozzi, pp. 237.
20. For more details on MTNs see Fabozzi and Fabozzi

The holder of this bond can be a Muslim or a non-Muslim. Whereas a Muslim will not be able to sell the bond, the non-Muslim holder can still sell it like any other bond. Islamic bonds will have a market in the conventional capital market.

Secondly, even for the Muslim holders of the bond, it may be possible to use it in the secondary market. Though it will be un-Islamic to sell it in the conventional market like an ordinary interest based bond yet he can use it to pay for his own purchases. He himself probably does not have an established credit worthiness to allow him to purchase on deferred payment basis but the bond that he is holding, issued by a reputable firm, may be acceptable as payment for his purchases. There will, of course, be an implicit discounting involved in this deal and hence an implicit price for the bond also.

If the bonds are based on back to back Istisna contract, then these bonds will have a secondary market only after the goods or infrastructure in question has been built and delivered as they would then represent ownership in the physical asset. The bonds will be in the form of a debt (and hence not negotiable) until the goods/infrastructure has been built and transferred to the buyer.

Advantages of Islamic Fixed Income Instruments

The above discussion indicates some of the possibilities for the introduction of fixed income Securities while remaining with in the Shariah-based PLS framework. If they materialize they will meet substantial market needs for the firms intending to operate on Islamic basis particularly in developed markets like those of US. The benefits that Islamic firms will get are obvious:

1. They will enable the Islamic firms to compete in the conventional capital market in mobilizing resources and will not face the lack of appropriate instruments to do so.
2. They will be able to get same tax advantage that their counter part firms are getting. The fixed cost of capital paid on bonds and notes can be made tax deductible as in case of interest-based bonds and certificates.
3. Besides the tax advantage, the firm has the ability to raise funds without issuing equity, which is a costly alternative.
4. The availability of fixed income financial instruments will give the Islamic firms more leeway for risk management.
5. Risks relating to the return on equity depend positively on the business risk and also on the debt equity ratio (the measure of financial

risk). Hence the more the debt the costlier becomes the equity, hence it is preferable to finance the growth by debt rather than equity and hence a spiral movement towards the maximum possible debt equity ratio (The famous M&M Proposition No. II). Despite the Islamic firms having a choice of fixed income Securities, they will not fall into this spiral trap because its capacity to issue bonds is limited to its need to make purchases or acquire leases for the firms.

6. The fixed income Securities as described above will provide Islamic firms ability to hedge against various price risks. As this hedge will be always through purchases or leases to meet their firms' needs, they will hardly be in the nature of pure speculative activities.

Potential of PLS based System to Mobilize Human Resources

Islamic principles of finance are conducive to developing new entrepreneurs in the economy. This is because the Islamic principles of finance make it mandatory that capital will be either cost free or will be a risk bearing capital. This makes a lot of difference for the new entrepreneur intending to enter the market. The difference is particularly substantial for the potential entrepreneurs who may have considerable human capital but may not have physical or financial capital to turn themselves into an entrepreneur. Such entrepreneurs will be hesitant to enter the entrepreneurs market with interest bearing capital because the stakes for them are too high. At stake is not only there own human capital and time and efforts but also the capital which is to be repaid with fixed return compounded periodically. Furthermore, the financial institutions operating on the basis of interest are not keen to look for such entrepreneurs. Already established businesses capable of offering sufficient collateral to guarantee repayment of capital with predetermined rate of return are more cherished customers of the interest based financial institutions. Availability of financing on Islamic principles provides encouragement to the potential entrepreneurs to enter the market as entrepreneurs (rather than seek a wage paid job to utilize their human capital).

Furthermore, the Islamic financial institutions may not have as strong a bias against the new entrepreneurs vis a vis established business as it is in the interest based system. If the financial institutions are operating on PLS basis, they will be keen to identify new entrepreneurs for prospects of getting better return on their investments.

This potential feature of Islamic financial system can and should also be exploited to uplift economic conditions of the lower economic strata of the society / community. The human resources employed in low paid jobs can

be motivated and helped to explore their entrepreneurial abilities to learn some skill or utilize the human capital that they may already be having to have a business of their own, which may help them to improve their economic condition.

The low-income sections of the society/community always have human resources who have potential to learn skills. Some of them may have already shown this potential in various ways in the market, though mostly in the informal sector and in an unorganized way. They may have also shown their entrepreneurial potential in one way or the other. Identifying these people and using Islamic finance to make them successful entrepreneurs will not only improve the economic conditions of the low income members of the community but will also yield better return on Islamic financing as it will be sharing the profits of these entrepreneurs. This application of Islamic financial principles will also give a practical vision about the economic system that Islamic institutions can develop.

Not much effort has been made to exploit this peculiar and unique aspect of Islamic financial system. The reason lies in the lack of proper institution arrangements to identify and mobilize such human resources and prepare them to attract financing from Islamic financing institutions.

There is need to develop institutions to utilize this peculiar feature of the Islamic financial system, and mobilize the human resources, to enable them exploit their potential entrepreneurial and human capital to turn them into successful entrepreneurs.

Working Capital Needs for Small Producers

Small producers often face a problem of working capital. They have the capacity to produce at a larger scale but lack of capital does not allow them to produce more or to improve their production technology. Being small and often lacking acceptable collateral they do not have access to bank loans. Furthermore being small they may not be having access or expertise to market their products at best prices. The profit sharing based financing too therefore may not be feasible. For such producers the Salam contract of trade can help meet their financing requirement.

A Salam contract would require a trader to approach a producer of certain goods for which there is already a known market, and make a contract with him to deliver the goods to him at some specified date in future. The trader will pay him in advance. The advance payment will meet the working capital needs of the producer allowing him to improve quantity and quality of his production. Such contracts may already be present in a community on informal basis but it is important that this is done formally under the

umbrella of an institution operating in the regular market. There is a possibility that the small producer, being in need of money, may contract a price less than that he gets otherwise for his produce. An institutional arrangement is needed that the contract is not utilized to improve the producer getting a better price for his product while meeting his financing needs also. This arrangement can work for the benefit of both the producers and the traders for all such commodities that have large profit margins for the middlemen. There are several products in this nature. Institutionalizing the Salam contract can ensure that the producer gets a price in between what he was getting earlier by selling to the immediate middlemen and the price that is paid by the final purchaser. This will be a system where the producer will be getting a financing (in terms of advance payment for his product) not at a discount but at a premium.

Potential for Developing an Islamic Futures Market

This may not be of immediate relevance in the context of the US economy. The point, however, is being made in the interest that in the long run this too can be pursued not only for the benefit of the Muslim community but also for the benefit of US economy at large and particularly for the benefit of US farmers.

The contemporary Futures markets are playing powerful economic role and the conventional banking system provides complimentary financial services to strengthen the institution. The Futures markets, in turn, serve as a source of strength for the conventional financial system. The contemporary concept of Futures and Futures market originally developed from the concept of forward trading, which was meant to enhance the exchange of agricultural commodities by providing the farmers protection against price uncertainties in the agricultural markets. This need for forward trading as means for enhancing output and exchange, recognized by the Western economies only a couple of centuries ago, was recognized in the Islamic economy fourteen centuries ago. However, the instruments and institutions that developed to cater to this need in the Western economies soon degenerated into a system that is now catering more to the needs of speculators than of the farmers and traders. "The members who are trading [in the Futures market] are typically speculators, those who hope to make a profit by exercising their trading acumen"[21]. The actual trade of goods is no more the objective of contemporary Futures markets. "In fact more than 99 per-

21. Robert W. Kolbe, Understanding Futures Markets, 2nd edition Scott Forman and Company, London, 1988, pp. 4.

cent of all Futures contracts are closed out by reversing trade rasher then through [making or receiving] delivery process"[22].

The Islamic concept of Salam trade provides a more powerful basis to promote the agricultural production and to help and protect the farmers not only against the price uncertainties but also against their inability to raise working capital for their production. The concept of Salam contract has two very distinct features. One, it makes it compulsory for the purchaser of the Salarn commodity to pay to the farmer full price in advance. Two, it obligates the purchaser to receive the delivery of the commodity before he decides to dispose it off. These two features of Salam contract aim at performing the following functions:

1. Reducing risks of farmers arising out of uncertainties of market prices of agricultural goods particularly at the harvest time.
2. Giving liquidity to the farmers by making out the advance payment of the price while making forward trade contract and hence meeting his working capital needs to meet his productions plans and targets.
3. Discouraging the traders (by forcing them to pay full price in advance) to venture in any pure speculative activity (without having any intention of actual trading or receiving delivery) through his forward trading contract.

Besides its being an Islamic concept, there is an independent case on its own merit to establish Salam based Futures Markets for contributing to the development of their economies[23].

The institutionalization of Salam based trade will on the one hand enhance business opportunities and on the other hand create opportunity for Islamic banks and financial institutions to operate in such areas that conventional banks may find difficult to compete because of their modus operandi does not allow for it.[24]

22. Robert W. Kolbe, Cit. Op. pp. 36.

23. For detailed discussion on this, see, M. Fahim Khan, Islamic Futures and their Markets, Islamic Research and Training Institute, Research Paper No. 32, Jeddah, 1995.

24. There is special case for Muslim countries to initiate Salam based Futures market in their economies. The rural financial markets in Muslim countries are very weak and in many cases non-existent. Several efforts have been made during last four decades to introduce formal financial institutions to meet the credit needs of the rural population with particular emphasis to agricultural and rural development. Despite that these institutions primarily aimed at providing cheap credit (compared to the normal cost of credit in the economy), they

Some proposals for Institutional Developments

In the light of the above discussion, it will be instrumental for the promotion of Islamic financial institutions, operating on PLS based principles, if efforts are made by the Muslim community to develop some of the following institutions. Though none of the institutions are required to benefit only the Muslim community and instead will benefit the entire society, but they are required to be initiated by the Muslim community.

Islamic Investment Opportunities Information Centers

The conventional system based on interest developed the Banks as an institution to minimize adverse selection arising out of asymmetry of information between the entrepreneur/firm and the investor. Using the economies of scale, the banks became able to reduce asymmetry of information and distinguish good firms from bad firms at very low cost. Islamic banks can do the same but they need to make more efforts than the interest-based banks to operate on the basis of PLS-principle. This is because of the following factors.

1. For an interest-based bank it is enough to know that the project is feasible and has the ability to sustain the payment of interest end repayment of capital. The bank is not concerned about the actually declared profit for income from the project. For the Islamic banks it will be very crucial that the profits are adequately calculated and declared regularly (so that the banks get their due share in the profit).
2. The problem of reducing of asymmetry of information, for an interest based bank is only at the time of signing the contract. Once the problem of asymmetry of information has been tackled and investment has been made, there is no more a problem of asymmetry of information. For Islamic banks, the asymmetry of information will be a perennial problem, as they need to have full information about the project and its performance through out the period of the financing contract.

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not only failed to develop a self sustaining rural financial markets but also failed to achieve the objectives primarily given to them. One study has concluded that it is unrealistic to expect rural financial markets to work well with interest-based financial intermediaries if the sector they serve is not economically healthy. Such a sector cannot afford to bear the market interest rates while the cheaper or subsidized rates have proved to be counter productive and defeating the very purpose for which hey are produced. (See, Robert C. Vogel and Dale W. Adama, "Rural Financial Markets in Low-income Countries" in C. K. Eicher and J. M. Staatz (Eds.), *Agricultural Development in the Third World* 2nd edition, The John Hopkins University Press, Baltimore and London, 1990).

3. The conventional banks have guarantee for the payment of capital and a predetermined return on it for the entire period of the loan contract. The Islamic banks investing on the basis of PLS principle will have to keep a more careful watch whether they should continue to keep their capital invested there or withdraw it and find other place to invest. Particularly if the project is suffering a loss in a particular year, taking capital out in that year will mean losing the capital. Keeping it there will have a chance that next year project may make profit and they may get their capital back in full with a positive return on it. The banks, therefore, would continuously need to make forecasts about the performance of the project they have invested in.

It should be noted that the conventional banks are losing their sign)finance for a US type of economy. Once there are institutions that are taking care of asymmetry of information and there are regulations ensuring full disclosure, the conventional banks do not have a case as a financial intermediary to reduce the asymmetry of information. The rapidly growing information technology is reducing the significance of conventional banks for an investor to find an investment opportunity to lend his funds. This fact is reflected in the fact that the lending role of financial institutions is declining in the United States[25].

There is more demand for equity participation because loan based financing is not earning enough return on capital. This is reflected in the growth of investment funds. Presently the investment funds are mostly catering to the needs of big investors. Small savers do not have easy access to these funds. The potential for financial intermediaries to find opportunities for investment on equity or profit sharing basis is high and will increase. Information cost for finding equity financing or PLS-based financing is high because of the factors mentioned above. This is a cost, which is to be minimized by appropriate institutional arrangements. Those interested in Islamic finance can take initiative in this respect.

Developing an information center for the Islamic investment opportunities may be the first step in this direction[26]. . . This center then can gradual-

25. Frederic S. Mishkin, *The Economics of Money, Banking and Financial Markets*, Fifth Edition, Addison-Wesley, 1997.

26. It is easy to observe that there is a lot of demand in the Muslim community for Islamic investment opportunities and they keep looking for them. Despite that there are so many Islamic investment opportunities in the world there is no institution that can help Muslim investors to get necessary information on these opportunities. Even the Harvard Data base on Islamic banking has not yet been able to give enough information to a small investor to decide where to put his savings to earn an Islamic return on them.

ly develop in to an institution that will serve as an intermediary for the investors to deploy their funds on Equity or PLS basis. The institution will then be playing a role of a bank that makes investments (on equity PLS basis and does not make interest based loan financing. This may not be a simple and easy task. There are several rather complicated things that it will have to take care of before it becomes a competitive and efficient Islamic financial intermediary or an Islamic bank working on the PLS-principle.

First it will have to solve the free-rider problem. To make the institution commercially feasible the center will have to charge for the information that it provides to the investors. The free-rider problem will occur when people who do not pay for the information take advantage of the information that someone else has paid for. Once the center develops itself into or generates independent full-fledged financial intermediary the free-rider problem will be solved. The most suitable form of financial intermediary suitable for the purpose of the Islamic investment on equity/PLS basis would be the venture capital firms. Since the equity in a venture capital firm is not marketable to anyone but to the venture capital firm, the other investors therefore are unable to take a free ride on the venture capital firm's efforts in identifying investment opportunities. In the initial stages when the center is operating only as means of exchange of information, the free-rider problem, however, will have to be tackled.

In the subsequent stage it will have to assume the role of rating the Islamic investment opportunities. Besides rating their economic performance they will have to make assessment of the extent to which the Islamic opportunities are adhering to Islamic principles of investment. Among small savers there is so much doubt in their minds about the extent to which the present Islamic banks in the world are really adhering to Islamic principles. There is so much diversity of opinion published frequently through the media on the subject that the common investor is confused and has no idea where to 'go to find the correct position. There is a need for an institution that can synthesize these opinions and can rate them according to their commitment and actual adherence to Islamic principles of financial operations.

At more advanced stage of its operation, the center may enter into such complex but useful activities as guaranteeing a minimum return or guaranteeing the safety of capital in the capacity of a third party. A substantial part of Muslim savers and investors may be the ones who may not be willing to subject their funds to any kind of risk. These investors may belong to that vulnerable section of the population who cannot afford taking any risk what so ever. Low-income groups of the population, old age pensioners, widows and orphans are some examples. They may prefer to keep their resources idle

or keep them in a current account in a conventional bank rather then invest them as a risk bearing capital. There is Shariah provision that Third Party Guarantee on rate of return or against loss of capital can be provided by a third party[27]. Availability of a reputable institution that can guarantee the safety of capital and/or some minimum return will be a service that will play an instrumental role in the promotion of the PLS based financial intermediaries.

Establishing an Islamic Corporate Trust

The conventional capital markets have a strong institution known as Corporate Trustee that has given support and strength to the wide spread popularity to interest based bonds. It serves as a third party to the contract and is representative of the interest of bondholders. They act as a watchdog for the bondholders by seeing to it that the issuer complies with all the covenants of the indenture. Since it is possible to have Islamic counterpart of bonds and fixed income Securities as discussed above, the development of Islamic capital market needs Islamic counter part of such Trusts.

In the context of US economy, it may perhaps be more practical and useful for the community to try to establish Islamic Corporate Trusts rather than establishing Islamic banks. The financial legal framework probably may not allow the establishment of an Islamic bank as easily as it may allow the establishment of a Corporate Trust. The presence of Trust will be sufficient for the establishment of Islamic bonds, notes and Securities that will fulfill the needs of the Islamic savers, investors and firms.

But for such trusts to develop, it is important that the Islamic corporate trustee be competent and responsible and has authority to serve as a watchdog. If an issuer of Islamic bond fails to pay in time, the Trustee should be able to take such action as may be necessary to protect the rights of bondholders. This would be a huge job. On the one hand it may require a collective action on the part of the Islamic firms and Islamic investors in the country as well as of Islamic banks in other parts of the world. On the other hand it may require the presence of a sizeable market of Islamic bonds.

Both aspects are however mutually re-enforcing. The market of islamic

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27. The OIC Fiqh Academy, Resolutions and Recommendations for the years 1985-1989, Resolution No. 5 of its fourth session held in Jeddah, on Feb. 6-11, 1988. For more discussion on this Monzer Kahf, "Sanadatul Qiradh wa Daman al Fareeq al Thalith wa Tatbeeqatuhs . . . (Mudharaba Securities and the Third Party Guarantee and its Application . . .)" Journal of King Abdulariz University: Islamic Economics, Jeddan Vol. 1, 1989. This includes the opinion of Sheikh Mustafa Zarqa on this subject.

bonds will develop if a strong trustee exists and the Trustee would gain strength if the Islamic bonds market gains momentum. The establishment of a trustee will have to take the lead. Since non Islamic firms may also be interested in issuing Islamic bonds to mobilize resources from Islamic investors, the establishment of Trust may be feasible from the very beginning. Besides doing the conventional work(of taking necessary prompt action in case of default, watching that the conditions laid down in the indenture for the Islamic bond issuer are being complied etc.) the Islamic Trustee will also see that the issue of Islamic bonds have complied with all Shariah requirements. The role of this trustee will be even stronger in terms of taking action against defaulting bond issuers. Since any legal penalty on defaulting bond issuers cannot be passed on to the bond holders the action against defaulting corporation will have to be quick and swift so that bond holders lose minimum opportunity cost of their capital due to delay in receiving their funds.

While in conventional framework, large banks are in a position to establish such a body, the Islamic banks currently may not be in a position to establish such a trust in the US market. Some joint effort will be needed on the part of the Muslim investors. The cost of running such a body can be charged to the beneficiaries in terms of fees and contributions. The default penalties will also be a source of funds for this body.

Entrepreneurs and Human Capital Development Centers

There are several NGOs working in the area of helping the less privileged members of the society in one way of the other. Few aims at turning them into an ambitious and trained entrepreneur capable of competing in the market and making his way to economic heights as any one from the privileged members of the society would aim at. There are no reasons why NGOs can not come into existence to aim on this particular need of the society. This is, of course, not an easy task as it requires very complex jobs to be undertaken, namely:

1. Identifying feasible projects that can possibly be taken up by their members in their constituency, individually or collectively
2. Providing opportunity to their members to acquire skills or upgrade their human capital for such projects
3. Providing training to the potential entrepreneurs in administration and marketing of their business
4. Providing training to the entrepreneurs in dealing with banks (including the ability to complete necessary documents and maintain the required accounts) and fulfil their obligations to the bank

5. Guarantee their members for compliance to the contractual obligations
6. Guarantee for the recovery of capital if the entrepreneurs defaults or violates the contractual obligations

The task however is worth undertaking and I believe the Muslim community in USA probably are most suited to take up this task which will not only develop their community but will also show to the world the peculiar and powerful feature of the Islamic financial system.

The US community should come forward to take up this task. This will be a community project that can be made self-financing and may not require charities and donation. What is needed is to develop an institution that will carry out all the functions listed above.

Research and Training

At present, research and training probably is the most important element needed for the institutions building for the support of Islamic Finance. The conventional financial system is operating, technically, at a very sophisticated level and has been supported by high quality research of several decades. The current Islamic finance movement, whether at the state level or by the Islamic banks and other bodies, looks for professional support qualified in the area of Islamic banking and finance to take necessary decisions and carry operations effectively and competitively. Very little is available in the current state of art to meet this need of Islamic financing institutions.

Development of institutions to promote an entirely new concept needs at least two pre-requisites:

1) High quality research into the needs and modalities of the institutions required to be created
2) Trained personnel to meet the manpower needs of these institutions

It can hardly be overemphasized that the subject of Islamic finance has been recognized as a scientific discipline, which can be taught and researched in the teaching institutions. This is reflected by the fact that not only some universities in the Muslim countries have faculties of Islamic economics and finance but also some well known universities in the West have introduced teaching of Islamic finance in their departments of economics[28]. The topics

28. For example, Loughborough University of Technology, UK has a graduate program in their economics department leading to a Master's degree in Islamic finance and Rice University in USA has introduced a chair in Islamic Economics, Finance and Management in their

of Islamic finance have gained significant recognition as subjects of Ph.D. theses in the economics and finance faculties in the Western universities. These are however not enough to meet the requirements of the Islamic finance movement. The research that has been done as the Ph.D. dissertations or otherwise[29] paid very little attention to the institutional development needed for promoting and strengthening the role of Islamic banking and other financial institutions and enabling them to compete with the conventional financial institutions while promoting their own cause. All current efforts in the area of Islamic finance whether by the Islamic banks or by the conventional banks (in introducing Islamic financial products) is overwhelmingly depending on the manpower that is educated and trained in conventional philosophy and methods of finance and management. As a result they are relying heavily on the existing instruments of interest based system to engineer their own projects. Efforts are needed to mobilize teaching and research in the areas needed for the promotion of Islamic Finance. The Muslim teachers students and researchers in the US universities and academic institutions can play a significant role in this respect by initiating/promoting teaching and research programs and projects in the area of Islamic finance in their respective institutions. Such efforts can bring significant fruits not only for the Muslim community in the US but will also serve the cause of Islamic finance in Muslim countries that are interested in implementing Islamic financial system but lack the appropriately qualified and trained manpower.

Islamic finance is constrained by several practical problems, which do not have easy solutions. Academic institutions can help them a lot in working out solutions of such problems. There is no specific list of such problems.In fact the problems may very from institution to institution and from region to region and from time to time. There is a need of continuous and strong interaction between scholars/researchers and the Islamic financial institutions in identification of issues and taking necessary steps in the form of research or training to solve the problem. Two areas particularly need attention of the Muslim scholars in the US.

1) Development of Resource centers that can provide material and advice on issues arising in contemporary Shariah-application in the field of Economics and Finance. There is no place where potential or existing institutions implementing Islamic financial system could go and find the information or professional advice it needs in the

29. For example, the research conducted by the Harvard University business and law professors under the umbrella of Middle Eastern Studies Department, now published by Vogel and Hayes III op. cit.

process of establishing Islamic financial information[30]. Absence of standardized contracts for different methods of Islamic financing is one example. It is often blamed in the international capital market that there is no single definition for an Islamic bank or standardized transactions "contract forms that can define the operations of an Islamic bank". This is basically an academic question. Similar observations and questions may be raised by FED and other relevant departments whenever Islamic financial institutions are introduced in USA. We need to have institutional arrangements to answer such questions. ISNA type organizations have to take strong initiative to develop such institutions. Since this caters to the needs of the Islamic financial institutions, the institutions will not face the problem of financing. The centers can be made commercially feasible. Establishment of such centers can be financed by the institutions that will be using them. The main issue is that who should take the initiative. Academic institutions particularly in the universities are the best places for establishing such institutions. The issues arising in the practice of Islamic financial principles are often not solvable merely by economist or Shariah scholars or financial analysts separately. They may require an interdisciplinary discussion. Academic institutions will have to take lead to establish institutions to meet this need. There are several institutions in the world both in the east and the West that serve as resource centers for general information on Islam. .But these institutions lack information and documentation on matters relating to Islamic finance.

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30. Harvard University, in its Middle Eastern Studies Department, is maintaining a database to provide statistical information on existing Islamic banks and financial institutions. Even as a data base it has yet to go a long way to provide comprehensive and consistent data on Islamic banking and finance.

31. Eddie George, Governor Bank of England made following remarks on Islamic banking. "Of course we have responsibility as banking supervisor to ensure that Islamic banking facilities offered in this country are in accordance with our national legislation. To do that we need to improve our understanding of what is involved . . . There are a number of issues that we need to address. One is that, as I understand it, there is no single definition of what constitutes Islamic banking. Different institutions interpret the acceptability of Islamic banking products in their own way. Individual boards of Shari'a advisers apparently have equal authority, so that in some jurisdictions, there is no definitive answer as to the status of a particular banking product". [Inaugural address of Governor of Bank of England in the International Conference on Islamic Banking and Finance Organized by Islamic Foundation in Leicester, UK, September 27-28, 1995.

2) Providing charter to certify professionalism. There is need for an institution that could give an award which could be recognized as a symbol of high professionalism and knowledge relevant to all matters relating to Islamic Banking and Finance. This will include, Fiqh and Shariah relevant to the field, theory and contemporary practice of Islamic banking and finance and Financial Analysis and portfolio management in Islamic perspective. The award will be a testimony of belief in and adherence to Islamic ethics of Business and finance, an award that would be respected by the industry of banking and finance. Whenever they need to look for professionalism in Islamic banking and finance, they look towards those who possess such an award. Such an award will have to be based on a program of rigorous professional training and set of exams and tests in these areas. Though initially, such an activity may need an initial capital as seed money, but in a very short period, the activity can become self sustained provided it is handled very professionally to meet the demand and standards of the industry of banking and finance in the world.

Conclusion

There is a great potential for the successful application of Islamic financial principles in the US not only for the benefit of Muslim community but also for the economy at large. London is fast developing as a center of international Islamic capital market. Financial centers in US too will respond to the demand of this growing phenomenon. Instead of making efforts to establish Islamic banks, it may be more fruitful to develop an institution that can facilitate the application of Islamic financial principles both for the general public as well as for the firms who want to apply Islamic principles in their economic and financial dealings. Besides developing institutions that can help develop Islamic counterparts of the conventional financial products in the market there is need to develop institutions that highlight the peculiar features of the Islamic financial system not only for the benefit of Muslim community but for the humanity at large. Linking the principles of Islamic finance with the human resource development is one such very feasible area to work on in the context of US economy.

The role of academics is extremely important in this respect. Development of effective teaching, training and research institutions is something that need to be pursued on priority to provide a professional base to the development of islamic financial system. The demand for the trained and qualified staff as well as of professional advice and consultancy in this field,

both from Islamic as well as from non-Islamic institutions is so much (and growing rapidly) that such academic efforts can be made even commercially feasible in a short period. Since the professionals qualified with Islamic orientation and research conducted in the context of islamic finance will be equally fit to work for the conventional institutions as well, the feasibility of teaching and research programs in this field is highly enhanced.

This paper will not be complete if I conclude it without pointing to the other unique feature of the Islamic financial system. In the beginning it was mentioned that the Islamic financial system works on the basis of two principles; Lending (without interest) and investment. All the discussion above has been confined to investment only. It will be instructive to say a few words about the lending without interest to complete the description of the Islamic financial system.

The verse of the Quran (2:276) quoted earlier refers to the elimination of interest from the roots. The same verse then refers to the phenomenon that *Allah Subhanahu Wa Ta'ala* wants to flourish instead. The alternative that He wants to see in place of Riba is the institution of spending in His cause. The charities and *infaq fisabeelillah* (spending in the cause of Allah) has always been an integral part of Muslim behavior (though in varying degrees from individual to individual). Very little effort has been made in Islamic societies to develop institutions to harness this behavior. Though some institutions are working in this area yet more effort is needed to bring such institutions to bring them at grass root level. Qardh Hasan is a concept that can mobilize substantial resources for meeting social needs of the society provided appropriate institutions are developed to operationalize this concept at large scale. It cannot be expected from the Islamic banks to organize this institution at a large scale. It is the function of charitable organizations, trusts, Associations etc to develop such institutions. Islamic banks however can play a catalytic role to assist these organizations to develop Qardh Hasan institutions. Since the Qardh Hasan resources can be channeled through the Islamic banks, they can directly benefit from such institutions. The two institutions will be re-enforcing each other.

There are huge amounts of resources in the Muslim world that are channeled to Qardh Hasan cause. Most of them channel through the informal channels. Institutionalizing them with the help of Islamic banks will contribute to the recognition of Islamic banks as not merely a commercial institution but a commercial institution with a commitment to developing an Islamic economic system.

It should be recognized that there is a tremendous amount of untapped potential of Qardh Hasan in Muslim societies in the following form.

1. People would not mind a return less than the market return if their capital is used for good causes
2. People would like to contribute funds for Qardh Hasan purposes for a certain period of time, provided their capital is guaranteed. They will not mind if there is no return at all
3. People would like to contribute funds to the Qardh Hasan fund even if substantial part (if not 100 percent) of their capital is guaranteed
4. People would like to donate funds without any guarantee or any return if they are sure that their funds will be judiciously used for the right causes.

How to mobilize the untapped funds in these categories or institutionalize the funds in these categories that are currently using the informal channels. Islamic banks can motivate NGOs and other interested parties by offering financial/investment services if they can develop institutional setup to tap the potential Qardh Hasan resources in Muslim societies and communities. Islamic banks can provide a bridge between such institution and the institutions needed for Entrepreneurs and Human Capital Development discussed earlier.

"It is imperative for Muslim Americans to create a viable economic future in this continent and the nuances of Islamic financing have been a major issue of concern in such an undertaking. We are confident that the collective advice of Muslim experts and practitioners, and the coming together of Muslim financial experts will not only help answer the many questions, offer ideas and opportunities but also give rise to ventures that will contribute and endow to Muslim financial strength in North America and beyond . . ." (Proceedings of the 1998 conference on Islamic Banking and Finance in America, Foreword, page 1, paragraph 2)

The Islamic Society of North America (ISNA) is an umbrella organization seeking to meet the needs of Muslims in America. Headquartered in Plainfield, Indiana, a suburb of Indianapolis, ISNA has more than three hundred community and professional organizations affiliated to it. Among its other functions, ISNA holds an annual convention (held during Labor Day weekend) which is attended by some 20,000 Muslims and the numbers are growing. It also organizes specialized conferences and seminars focusing on the various aspects of Muslims living in America, that range from focus on Islam in America and Islam in American Prisons conferences (held annually during USA Independence Day weekend) to Islamic Banking and Finance in America and Muslims and the Information Super Highway. ISNA is an active participant in interfaith dialogs and serves as a resource for the growth of specialized Muslim institutions in various areas. ISNA publishes a news and views journal, the Islamic Horizons, that reaches some 50,000 readers among its members, academic institutions, nodes of power in America and interfaith communities.